UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 1707—August Term, 1994

(Argued: June 8, 1995 Decided: September 13, 1995)

Docket No. 95-7008

MCMAHAN & COMPANY; FROLEY, REVY INVESTMENT CO., INC.; WECHSLER & KRUMHOLZ, INC.; and DON THOMPSON, on behalf of himself and all others similarly situated,

Plaintiffs-Appellees,

—v.—

WHEREHOUSE ENTERTAINMENT, INC.; LOUIS A. KWIKER; GEORGE A. SMITH; MICHAEL T. O'KANE; LAWRENCE K. HARRIS; DONALD E. MARTIN; JOEL D. TAUBER; FURMAN SELZ MAGER DIETZ & BIRNEY, INC.; WEI ACQUISITION CORP.; WEI HOLDINGS, INC.; and ADLER & SHAYKIN,

Defendants-Appellants.

Before:

OAKES, MINER, and LEVAL,
Circuit Judges.

Appeal by permission from an order entered in the United States District Court for the Southern District of New York (Lowe, J.) denying, in part, defendants' motion for summary judgment, the court having ruled that plaintiffs may be entitled to recover benefit-of-the-bargain damages for alleged securities law violations and that a no-action clause in the underlying indenture did not bar plaintiffs' federal securities law claims.

Affirmed in part, reversed in part.

PHILIP K. HOWARD, New York, NY (Linda C. Goldstein, Howard, Darby & Levin, New York, NY, Judith L. Spanier, Abbey & Ellis, New York, NY, of counsel), *for Plaintiffs-Appellees.*

DENNIS J. BLOCK, New York, NY (Joseph S. Allerhand, Miranda S. Schiller, Howard L. Kneller, Weil, Gotshal & Manges, New York, NY, of counsel), *for Defendants-Appellants.*

(Simon M. Lorne, General Counsel, Jacob H. Stillman, Assoc. Gen. Counsel, Susan S. McDonald, Special Counsel, Diane V.

White, Senior Counsel, and Paul Gonson, Solicitor, Securities and Exchange Commission, Washington, DC) submitted a brief as *amicus curiae* for the Securities & Exchange Commission.

MINER, *Circuit Judge*:

Defendants-appellants appeal from an order entered on August 12, 1994 in the United States District Court for the Southern District of New York (Lowe, J.) denying, in part, defendants' motion for summary judgment, the court having determined, *inter alia*, that benefit-of-the-bargain damages are available to plaintiffs under section 11 of the Securities Act of 1933 (the "1933 Act") and under section 10 of the Securities Exchange Act of 1934 (the "1934 Act"), and that the no-action clause in the underlying indenture did not bar plaintiffs' federal securities law claims. The district court identified these issues as warranting interlocutory review and certified its order, pursuant to 28 U.S.C. § 1292(b). A panel of this Court granted defendants' motion for leave to appeal on January 3, 1995.[1]

For the following reasons, we affirm so much of the district court's order as allows plaintiffs to recover benefit-of-the-bargain damages under section 10 of the 1934 Act and as holds that the no-action clause in the underlying indenture does not bar plaintiffs' federal securities law claims. We reverse the district court's order to the

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[1] Plaintiffs' cross-motion for leave to appeal the remaining issues decided by the district court in its August 12, 1994 order was denied by the panel, and we will not consider those issues.

extent that it allowed benefit-of-the-bargain damages under section 11 and refused to consider defendants' statutorily prescribed affirmative defense.

BACKGROUND

In July of 1986, defendant-appellant Wherehouse Entertainment, Inc. ("Wherehouse") issued 6.25% Convertible Subordinated Debentures (the "Debentures") at $1,000 par value. Plaintiffs allege that one of the key selling features of the Debentures was the right of holders to tender the Debentures to Wherehouse in the case of certain triggering events that might endanger the value of the Debentures. One such triggering event would occur if Wherehouse "consolidate[d] or merge[d] . . . unless approved by a majority of the Independent Directors." "Independent Director" was defined in the offering materials as a director of the company who was not a recent employee but who either was a member of the board of directors on the date of the offering, or who subsequently was elected to the board by the then-Independent Directors.

On November 19, 1987, Shamrock Holdings, Inc. announced that it planned to commence a tender offer for Wherehouse's common stock. Subsequently, defendant Adler & Shaykin, an investment partnership, formed defendants WEI Acquisition Corp. and WEI Holdings, Inc., and submitted a bid for the Wherehouse stock. On December 20, 1987, the Board of Directors of Wherehouse unanimously approved, with one abstention, a merger with WEI Acquisition Corp. and WEI Holdings, Inc. The Board's approval of the merger was announced the following day, December 21, 1987. This news seemed to have a positive effect on the Debentures,

which traded on the open market. The price of the Debentures went from 47% of par on the previous trading day, December 18, to 49% of par on the announcement date, December 21. On December 23, 1987, Wherehouse filed a Schedule 14D-9 with the Securities and Exchange Commission in which the company advised that the right to tender would not be triggered by the merger.

Despite the company's announcement, plaintiffs attempted to tender their Debentures to Wherehouse following the merger, seeking a redemption price of 106.25% of par, pursuant to the right to tender. Wherehouse refused to redeem the Debentures at this price, claiming that the right to tender had not been triggered because the Board had approved the merger. Instead, all debentureholders were given the opportunity to tender their securities at 50.72% of par, which represented the Debentures' conversion value on the date preceding the merger. Also, pursuant to a "Supplemental Indenture," the debentureholders no longer had a right to convert the Debentures into common stock.

Based on the foregoing, plaintiffs commenced two separate actions (the "McMahan" action and the "Thompson" action), which ultimately were consolidated. Plaintiffs claim that they were misinformed about the true nature of the right to tender, that the right was illusory, and that the registration statements and the prospectus, as well as oral representations made in connection therewith, were materially misleading. They contend that the right was portrayed as valuable to debentureholders, creating a duty on the part of the "Independent Directors" to act in the debentureholders' interest. They allege federal securities claims arising under, *inter alia*, section 11 of the 1933 Act, 15 U.S.C.

§ 77k, for a misleading registration statement and under section 10 of the 1934 Act, 15 U.S.C. § 78j, for fraud in connection with a sale of securities.

In the McMahan action, defendants made a motion to dismiss, which later was converted into a motion for summary judgment. The district court, adopting the recommendation of the magistrate judge, granted summary judgment in favor of defendants and dismissed the complaint. We reversed that decision, finding that there was a genuine issue of material fact as to whether a reasonable investor could have been misled by the offering materials. *See McMahan & Co. v. Wherehouse Entertainment, Inc.*, 900 F.2d 576, 578 (2d Cir. 1990) ("*McMahan I*"), *cert. denied*, 501 U.S. 1249 (1991).

On remand, the defendants again moved for summary judgment. It is this second motion that gives rise to this appeal. As to the issues raised in this appeal, the district court denied defendants' motion, ruling, *inter alia*, that (1) the no-action clause in the indenture did not operate to bar plaintiffs' federal securities law claims; (2) plaintiffs may recover benefit-of-the-bargain damages under section 11 of the 1933 Act and section 10 of the 1934 Act. *See McMahan & Co. v. Wherehouse Entertainment, Inc.*, 859 F. Supp. 743 (S.D.N.Y. 1994). Subsequently, the court certified an order delineating these two rulings for an interlocutory appeal, pursuant to 28 U.S.C. § 1292(b). A panel of this court granted leave to appeal on January 3, 1995.

DISCUSSION

I. Benefit-Of-The-Bargain Damages

Defendants contend that the district court erred in ruling that plaintiffs could recover benefit-of-the-bargain damages under section 11 of the 1933 Act and under section 10 of the 1934 Act. "Summary judgment may be granted if, upon reviewing the evidence in the light most favorable to the nonmovant, the court determines that there is no genuine issue of material fact and that the movant is entitled to judgment as a matter of law." *Richardson v. Selsky*, 5 F.3d 616, 621 (2d Cir. 1993). "We review a grant of summary judgment *de novo*." *Peoples Westchester Sav. Bank v. FDIC*, 961 F.2d 327, 330 (2d Cir. 1992). Each of defendants' claims will be discussed in turn.

A. Section 11 of the 1933 Act

Section 11(a) of the 1933 Act imposes civil liability on issuers and other signatories of a registration statement if the registration statement contains material misstatements or omissions and the plaintiffs acquired the securities without knowledge of such misrepresentations. *See* 15 U.S.C. § 77k(a); *Akerman v. Oryx Communications, Inc.*, 810 F.2d 336, 340 (2d Cir. 1987); *see also Greenapple v. Detroit Edison Co.*, 618 F.2d 198, 203 n.9 (2d Cir. 1980). Section 11(e) of the 1933 Act specifically provides the measure of damages in such suits:

> The suit . . . may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was

> brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages [as calculated under subsection (1), above] . . . .

15 U.S.C. § 77k(e). While any decline in value is presumed to be caused by the misrepresentation in the registration statement, *see Greenapple*, 618 F.2d at 203 n.9, section 11(e) provides the following affirmative defense:

> [I]f the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from [the] part of the registration statement . . . [that contains the material misstatement or omission], such portion of or all such damages *shall not be recoverable*.

15 U.S.C. § 77k(e) (emphasis added). This defense is known as the defense of "negative causation." *See Akerman*, 810 F.2d at 340. Accordingly, where a defendant proves that the decline in the value of the security in question was not caused by the material omissions or misstatements in the registration statement, plaintiff is not entitled to recover any damages. *See id.*

Here, the district court erred in ruling that plaintiffs may recover benefit-of-the-bargain damages under section 11 and that the market value was "irrelevant to Plaintiffs' claimed economic losses." 859 F. Supp. at 751. "It is axiomatic that [t]he starting point in every case involving construction of a statute is the language itself." *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 685 (1985) (internal quotations omitted). The plain language of section 11(e) prescribes the method of calculating damages, *see* 15 U.S.C. § 77k(e), and the court

must apply that method in every case. *Cf. Versyss Inc. v. Coopers & Lybrand*, 982 F.2d 653, 657 (1st Cir. 1992) (recognizing that, in general, section 11 should not be "extended beyond its normal reading"), *cert. denied*, 113 S. Ct. 2965 (1993). Plaintiffs' claim that section 11(e), like section 11(g),[2] only provides a "cap" on damages, rather than the "measure" of damages, is belied by the plain language of the statute. Indeed, section 11(e) is entitled "Measure of damages," and the statutory scheme requires courts to apply the prescribed formula in every section 11 case. The record indicates that there was a substantial decline in the market price of the Debentures between the date plaintiffs purchased the Debentures and the date of the merger. This decline in market value permits plaintiffs to recover damages under the statutory scheme.

Defendants argue that the claim for damages under section 11 should be dismissed because they have established the defense of negative causation. The district court, however, ruled that negative causation was irrelevant to plaintiffs' section 11 claim in view of its determination that benefit-of-the-bargain damages were available and therefore failed to consider the defense. Because the plain language of section 11 allows this defense, the district court, on remand, must allow defendants the opportunity to prove that the decline in value was not caused by the alleged misstatements in the registration statements. *See Akerman*, 810 F.2d at 342. When considering defendants' defense, the district court should apply the following principles.

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[2] Section 11(g) provides that "[i]n no case shall the amount recoverable under [section 11] exceed the price at which the security was offered to the public." 15 U.S.C. § 77k(g).

First, the term "value" in section 11(e) was intended to mean the security's true value after the alleged misrepresentations are made public. Even plaintiffs have suggested that damages be measured by the difference between the amount paid and the amount that defendants were willing to redeem the Debentures for after the merger was announced, i.e., the value of the Debentures after the alleged misrepresentations were disclosed. Accordingly, the district court's reference to "promised value" was misplaced because promised value is irrelevant to this calculation.

Second, the value of a security may not be equivalent to its market price. Congress' use of the term "value," as distinguished from the terms "amount paid" and "price" indicates that, under certain circumstances, the market price may not adequately reflect the security's value. *See Beecher v. Able*, 435 F. Supp. 397, 404-05 (S.D.N.Y. 1977) (adjusting the market price to account for panic selling in the market that was unrelated to the misrepresentations in the registration statements); *Grossman v. Waste Management, Inc.*, 589 F. Supp. 395, 415-16 (N.D. Ill. 1984) (holding that subsequent fraud on the market may make market price an unreliable indication of the security's value). However, instances where the market price of a security will be different from its value are "unusual and rare" situations. *In re Fortune Sys. Sec. Litig.*, 680 F. Supp. 1360, 1370 (N.D. Cal. 1987). Indeed, in a market economy, when market value is available and reliable, "market value will always be the primary gauge of an enterprise's worth." *Mills v. Electric Auto-Lite Co.*, 552 F.2d 1239, 1247 (7th Cir.), *cert. denied*, 434 U.S. 922 (1977). Moreover, even where market price is not completely reliable, it serves as a good starting point in determining value. *See Beecher*, 435

F. Supp. at 406. In this case, market price appears to be the most reliable gauge of the Debentures' true value and, at the very least, an excellent starting point. Thus, the district court, in applying the statutory damages formula, should begin with the market price to determine the true value of the Debentures.

Finally, as a general rule, a "price decline before disclosure may not be charged to defendants." *Akerman*, 810 F.2d at 342; *see also Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 586-88 (E.D.N.Y. 1971). The defendant, however, bears the burden of proving that the price decline was not related to the misrepresentations in the registration statement. *See* 15 U.S.C. § 77k(e); *see also Akerman*, 810 F.2d at 340.

The district court should address these issues in the first instance, being most familiar with the circumstances of this case.

B. Section 10 of the 1934 Act

Plaintiffs' section 10 claim for damages stands on a different footing. Section 28(a) of the 1934 Act provides that "no person permitted to maintain a suit for damages under the provisions of this chapter shall recover . . . a total amount in excess of his actual damages on account of the act complained of." 15 U.S.C. § 78bb. The statute does not prescribe a particular method of calculating damages, and, in fact, we have allowed benefit-of-the-bargain damages under section 10, *id.* § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder.

In *Osofsky v. Zipf*, 645 F.2d 107 (2d Cir. 1981), the plaintiffs were offered a specific price if they tendered their common stock in connection with a tender offer. Plaintiffs tendered their stock, but received a lesser

amount than they originally had been offered. *Id.* at 109-10. We held that benefit-of-the-bargain damages, under Rule 10b-5, were particularly appropriate in the context of tender offers where, despite the fraud, the shareholders normally will receive an amount in excess of market value. *Id.* at 114. We noted that the key to awarding benefit-of-the-bargain damages is the degree of certainty to which they can be established. *Id.*

In *Levine v. Seilon, Inc.*, 439 F.2d 328, 334 (2d Cir. 1971) (Friendly, J.), the court stated that, under Rule 10b-5, a defrauded buyer of securities was "entitled to recover only the excess of what he paid over the value of what he got, not, as some other courts had held, the difference between the value of what he got and what it was represented he would be getting." In *Osofsky*, we noted that this language in *Levine* was dicta, and we distinguished *Levine* on the ground that damages sustained by a defrauded buyer of securities are more speculative and thus different from the damages of a defrauded seller who does not get what he was promised. *Osofsky*, 645 F.2d at 112. In cases following *Osofsky*, we have focused on the plaintiff's ability to establish benefit-of-the-bargain damages with some reasonable degree of certainty. For example, in *Barrows v. Forest Labs., Inc.*, 742 F.2d 54, 59-60 (2d Cir. 1984), we refused to allow benefit-of-the-bargain damages where such damages were based on the speculation of what plaintiff's securities would have been worth if the company had disclosed its true financial forecast. More recently, in *Commercial Union Assurance Co. v. Milken*, 17 F.3d 608, 614-15 (2d Cir.), *cert. denied*, 115 S. Ct. 198 (1994), we acknowledged the possibility of awarding benefit-of-the-bargain damages in a Rule 10b-5 case, but declined to do so because the plaintiff's claims were speculative.

In this case, we believe that plaintiffs could establish benefit-of-the-bargain damages with reasonable certainty. We acknowledge, however, that this is not a case like *Osofsky*, where plaintiffs were offered a certain price during a tender offer and then received some lesser amount. In this case, plaintiffs purchased debentures, allegedly relying in part on the possibility that a merger that was not approved by the Independent Directors might occur and thus trigger the right to tender. This possibility, we have previously held, could reasonably be considered a "valuable right" to plaintiffs. *See McMahan I*, 900 F.2d at 579. Whether plaintiffs can establish, with a reasonable degree of certainty, the amount of that value is a different question.

Plaintiffs contend that determining damages in this case is a simple task—upon a merger, they are entitled to 106.25% of par for each Debenture. In reality, the matter is more complex than plaintiffs' contention would indicate. Because the value of plaintiffs' right to tender was contingent on the occurrence of certain events, the value of this right is somewhat speculative. Nevertheless, if plaintiffs could establish, under their theory of the case, that independent directors, acting on behalf of the debentureholders, would not have approved this merger, then damages could be assessed at the promised redemption of par plus 6.25%.

II. The No-Action Clause

Defendants contend that the district court erred in ruling, as a matter of law, that the no-action clause found in the Indenture cannot operate to waive plaintiffs' rights under the 1933 and 1934 Acts. The no-action clause is contained in section 8.06 of the Indenture and provides as follows:

Limitation on Suits. A Securityholder may pursue any remedy with respect to this Indenture or the Securities only if:

(1) the Holder gives to the [Indenture] Trustee written notice of a continuing Event of Default;[3]

(2) the Holders of at least 25% in principal amount of the Securities make a written request to the Trustee to pursue the remedy;

(3) such Holder or Holders offer to the Trustee indemnity satisfactory to the Trustee against any loss, liability or expense;

(4) the Trustee does not comply with the request within 60 days after receipt of the request and the offer of indemnity; and

(5) during such 60-day period the Holders of a majority in principal amount of the Securities do not give the Trustee a direction inconsistent with the request.

Section 14 of the Debentures states in relevant part: "Securityholders may not enforce the Indenture or the Securities except as provided in the Indenture."[4]

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[3] Section 8.01 of the Indenture states that an event of default occurs if, *inter alia*, "the Company defaults in the payment of the principal of any Security when the same becomes due and payable, whether at maturity, upon redemption or otherwise[, or] the Company fails to comply with any of its other agreements in the Securities or this Indenture."

[4] Section 8.07 of the Indenture provides that debentureholders are excused from complying with the No-Action clause in suits based on nonpayment of principal and interest on or after the due dates expressed in the Debenture and in suits based on the right to convert a Debenture to common stock. This is a requirement of section 316(b) of the Trust Indenture Act, 15 U.S.C. § 77ppp(b).

Such no-action clauses frequently are included in indentures to limit suits arising from those agreements. *See UPIC & Co. v. Kinder-Care Learning Ctrs., Inc.*, 793 F. Supp. 448, 454 (S.D.N.Y. 1992) (citing American Bar Foundation, *Commentaries on Model Debenture Indenture Provisions*, 232-34 (1971)). "These clauses are strictly construed," *Cruden v. Bank of New York*, 957 F.2d 961, 968 (2d Cir. 1992), and have been enforced in a variety of contexts in both federal and state courts, *see, e.g., Friedman v. Chesapeake and Ohio Ry. Co.*, 261 F. Supp. 728, 729-31 (S.D.N.Y. 1966) (action to accelerate the time of payment on bonds), *aff'd*, 395 F.2d 663 (2d Cir. 1968), *cert. denied*, 393 U.S. 1016 (1969); *Greene v. New York United Hotels, Inc.*, 260 N.Y.S. 405, 406-07 (1st Dep't 1932) (action based on non-payment of coupons on debenture bonds), *aff'd*, 261 N.Y. 698 (1933).

In this case, plaintiffs failed to comply with the no-action clause, and, as a result, the district court ruled that their state-law claims were barred. In regard to the federal securities law claims, however, the district court ruled that the no-action clause was inoperable because it infringed on plaintiffs' substantive rights under the securities laws. The court based its conclusion on the anti-waiver provisions of both the 1933 and 1934 Acts, which provide, in pertinent part, that "[a]ny condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of [the Acts or any rule or regulation of the Commission or an exchange] . . . shall be void." 15 U.S.C. §§ 77n; *id.* § 78cc(a).

Defendants argue that the no-action clause does not constitute a "waiver," but, rather, establishes a procedure that must be followed before an action may be brought.

They attempt to analogize the no-action clause to an arbitration clause, and claim that both merely are procedural limitations. We disagree.

Arbitration clauses are enforceable under federal securities laws because they are procedural in nature and do not serve to waive compliance with the provisions of substantive law. *See Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 238 (1987) (stating that "the SEC has sufficient statutory authority to ensure that arbitration is adequate to vindicate Exchange Act rights"). The no-action clause in this case can operate to bar a minority plaintiff class from exercising its substantive rights under federal securities law upon the vote of a majority of the debentureholders. Further, a plaintiff's inability to indemnify the Trustee, as required by the no-action clause here, would bar that plaintiff from commencing a securities law claim. The statutory framework of the 1933 and 1934 Acts compels the conclusion that individual securityholders may not be forced to forego their rights under the federal securities laws due to a contract provision. *See Kusner v. First Pa. Corp.*, 531 F.2d 1234, 1239 (3rd Cir. 1976) (finding no "authority for the proposition that a `no action' provision in an indenture effectively bars a direct action based upon the federal securities laws"). Thus, the district court properly found that actions based on federal securities laws may not be precluded by the no-action clause.

CONCLUSION

We affirm so much of the district court's order as determined that benefit-of-the-bargain damages are available under section 10 of the 1934 Act and as determined that the no-action provision in the Indenture could

not bar plaintiffs' securities law claims. We reverse the district court's order to the extent that the court ruled that benefit-of-the-bargain damages were available under section 11 of the 1933 Act. On remand, the district court is to apply the measure of damages specifically provided under section 11(e) of the 1933 Act in accordance with this opinion.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

Filed December 21, 1995

McMahan & Company et al. v.
Wherehouse Entertainment, Inc. et al.
88 Civ. 0321 (MJL);

Don Thompson v. Wherehouse Entertainment, Inc. et al.
88 Civ. 9040 (MJL)

ORDER

Before the Court is Defendants' motion for summary judgment, on which this Court previously ruled in its August 10, 1994 opinion and order ("August 1994 Opinion"), and on which the Second Circuit ruled in a September 13, 1995 decision. Still at issue are Plaintiffs' claims under Section 11 of the Securities Act of 1933 ("Section 11").

The background of this action is set forth in this Court's August 1994 Opinion and the Second Circuit's September 13, 1995 decision and need only be briefly summarized here. Plaintiffs are holders of debentures ("Debentures") issued by Defendant Wherehouse Entertainment, Inc. ("Wherehouse"). Plaintiffs claim that a key selling feature of the Debentures was the right of holders to tender ("Right to Tender") the Debentures to Wherehouse at 106.25% of par in the event of certain triggering events including Wherehouse's merger with another company, unless that merger was approved by a majority of "Independent Directors." On December 20, 1987, the Board of Directors of Wherehouse approved a merger

("Merger") with WEI Acquisition Corp. and WEI Holdings, Inc. Following the Merger, Plaintiffs attempted to exercise the Right to Tender, but Wherehouse refused to redeem the Debentures at 106.25% of par because the Board had approved of the Merger. Subsequently, Plaintiffs initiated this suit, claiming, *inter alia*, that they were misinformed about the true nature of the Right to Tender, that the right was illusory, and that they were not informed that the right would not be triggered by a friendly acquisition of Wherehouse. Plaintiffs allege a variety of claims including claims under Section 11.

In June 1993, Defendants moved for summary judgment on Plaintiffs' claims. With respect to Plaintiffs' Section 11 claims, Defendants argued that the decline in the market price of Plaintiffs' securities was not attributable to their alleged misrepresentations because that decline occurred *prior* to the December 21, 1987 disclosure that Wherehouse's Board of Directors had approved the Merger. Defs.' Mem. at 15-19. Plaintiffs did not dispute Defendants' showing of negative causation regarding a decline in market value,[1] Pls.' Mem. at 40-43, but argued that "[t]he 'negative causation' proviso" was inapplicable to their case. *Id.* at 43. Instead, Plaintiffs claimed entitlement to benefit-of-the-bargain damages, i.e., damages "measured against the promised value" of Plaintiff's debentures. *Id.*

In its August 1994 Opinion, this Court agreed with Plaintiffs' argument and concluded that Plaintiffs could seek damages based on the "promised value" of their securities that was lost due to fraud. Aug. 1994 Op. at 18-19. Defendants appealed this portion of the August 1994 Opinion to the Second Circuit, which, on September 13, 1995, ruled in Defendants' favor.[2] The Court of Appeals held that Plaintiffs may

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[1] While Plaintiffs argued that "the depreciation in value results from defendants' failure to honor the terms of the Holder's Right to Tender," Plaintiffs referred to a depreciation from the *promised value* of the Debentures, not from the price they paid for those securities. Pls.' Mem. at 42 ("the loss is not market loss, but the loss of a promised benefit").

[2] Defendants also raised other grounds for appeal which the Second Circuit overruled.

not recover benefit-of-the-bargain damages under Section 11 and that the concept of "promised value" is irrelevant to a calculation of Section 11 damages. *McMahan & Co. v. Wherehouse Entertainment, Inc.*, No. 95 Civ. 7008, slip op. at 6-8 (2d Cir. Sept. 13, 1995). The Court of Appeals remanded Defendants' motion to this Court for consideration of Defendants' "negative causation" defense. *Id.* at 7.

After careful review of the parties' summary judgment submissions, the Court concludes that Defendants have successfully established a negative causation defense to Plaintiffs' Section 11 claims. Defendants' submissions demonstrate that: (1) Plaintiffs' debentures, which traded at close to 100% of par when first issued in July 1986, were trading at about 60% of par by October 1987, at about 50% of par by November 1987, Defs.' and Pls.' Stmts. Pursuant to Local Rule 3(g) at ¶ 5, and at about 47% of par on December 18, the last trading day before Wherehouse approved the Merger, Defs.' Mem. at 9-10; Defs.' Ex. 3 (list of daily closing prices); (2) Defendants first publicly disclosed that the Right to Tender would not be triggered by the Merger shortly after the occurrence of the Merger in late December 1987, Defs.' Mem. at 17 and submissions cited therein; Pls. Mem. at 17 and submissions cited therein; and (3) pursuant to a supplemental indenture issued after the Merger agreement was approved, debenture holders were, subsequent to the Merger, allowed to cash in their debentures at 50.72% of par, Defs.' Stmt. Pursuant to Local Rule 3(g) at ¶ 6; Defs.' Mem. at 17.

Thus, the "true value" (as opposed to "promised value") of Plaintiffs' securities at the time of suit—i.e., the value at which Defendants were willing to redeem those securities after the December 1987 disclosure[3]—was no less than the value of those Debentures prior to the disclosure which allegedly revealed Defendants' misrepresentations. Defen-

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[3] As noted by the Second Circuit, "[e]ven plaintiffs have suggested that damages be measured by the difference between the amount paid and *the amount that defendants were willing to redeem the Debentures for after the merger was announced, i.e., the value of the Debentures after the alleged misrepresentations were disclosed.*" *McMahan, supra*, slip op. at 8 (emphasis added).

dants cannot, of course, be held liable under Section 11 for a price decline occurring prior to such disclosure. *See Akerman v. Oryx Communications, Inc.*, 810 F.2d 336, 342 (2d Cir. 1987). Thus, Defendants have demonstrated that their alleged misrepresentations did not cause the decline in the price of Plaintiffs' Debentures.[4] Accordingly, Defendants are entitled to summary judgment on Plaintiffs' Section 11 claims, which do not seek legally congnizable damages. *See* 15 U.S.C. 77k(e) (measure of damages and negative causation defense under Section 11); Fed. R. Civ. P. 56(c) (summary judgment standard). The parties are to submit a Joint Pre-Trial Order on or before February 19, 1996.

It is So Ordered.

Dated: New York, New York
December 19, 1995

MARY JOHNSON LOWE
United States District Judge

[4] As already indicated, Plaintiffs' opposition papers do not dispute that Defendants have established negative causation with respect to the decline in the *market value* of the Debentures. Instead, Plaintiffs raise arguments, subsequently rejected by the Second Circuit, that they are entitled to benefit-of-the-bargain damages based on promised value.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

Filed August 12, 1994

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88 Civ. 0321 (MJL)

MCMAHAN & COMPANY, FROLEY, REVY INVESTMENT CO., INC. and WECHSLER & KRUMHOLZ, INC.,

Plaintiffs,

—against—

WHEREHOUSE ENTERTAINMENT, INC., LOUIS A. KWIKER, GEORGE A. SMITH, MICHAEL T. O'KANE, LAWRENCE K. HARRIS, DONALD E. MARTIN, JOEL D. TAUBER, FURMAN SELZ MAGER DIETZ & BIRNEY INCORPORATED, WEI ACQUISITION CORP., WEI HOLDINGS, INC. and ADLER & SHAYKIN,

Defendants.

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88 Civ. 9040 (MJL)

DON THOMPSON, on behalf of himself and all others similarly situated,

Plaintiff,

—against—

WHEREHOUSE ENTERTAINMENT, INC., LOUIS A. KWIKER, GEORGE A. SMITH, MICHAEL T. O'KANE, LAWRENCE K. HARRIS, DONALD E. MARTIN, JOEL D. TAUBER, and FURMAN SELZ MAGER DIETZ & BIRNEY INCORPORATED,

Defendants.

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OPINION AND ORDER

MARY JOHNSON LOWE, D.J.

Before the Court are motions for partial summary judgment and summary judgment filed by plaintiffs and defendants respectively, and a report and recommendation ("R & R") by a United States Magistrate Judge addressing these motions in part. The motions were referred to Magistrate Judge Kathleen A. Roberts who recommends that this Court grant defendants' motion for summary judgment and dismiss the actions against it. For the reasons below, this Court adopts in part and declines to adopt in part this recommendation. Defendants' motion for summary judgment is granted in part and denied in part. Plaintiffs' motion for partial summary judgment is dismissed as moot.

BACKGROUND

The background of this action is also set forth in the R & R, in prior opinions of this Court, and in an opinion by the Court of Appeals.[1] The plaintiffs in the *McMahan* action, composed of financial institutions, and individual plaintiff Don Thompson in the *Thompson* action (collectively, "Plaintiffs") are holders of 6 1/4% convertible subordinated debentures (the "Debentures") issued in July of 1986 by Wherehouse Entertainment, Inc. ("Wherehouse"), a retailer of home entertainment and information software. The Debentures are due July 1, 2006. The governing indenture (the "Indenture"), between Wherehouse and Trustee Bank of America, provides debentureholders with a right to tender their debentures at 106.25% of par to Wherehouse upon the occurrence of certain "triggering events" listed therein. Indenture, § 5.01. One such event occurs when Wherehouse consolidates or merges with another company, unless that merger was approved by a majority of "Independent Directors," a term described in the Indenture. Indenture, § 5.02. This "right to tender" is also described in the prospectus through which the debentures were advertised.

On November 19, 1987, Shamrock Holdings, Inc. ("Shamrock") announced that it would commence a tender offer for Wherehouse's common stock. Subsequently, defendant Adler & Shaykin, an investment partnership, formed defendants WEI Acquisition Corp. and WEI Holdings, Inc., and bid for the Wherehouse stock. On December 20, 1987, the Board of Directors of Wherehouse unanimously approved, with one abstention, a merger with WEI Acquisition Corp. and WEI

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[1] The defendants to the *McMahan* action made a prior motion to dismiss pursuant to Rules 12(b)(1) and 12(b)(6) of the Federal Rules of Civil Procedure. This motion was treated by Magistrate Judge Roberts as one for summary judgment. On May 22, 1989, this Court adopted the recommendation of the Magistrate Judge, granted summary judgment in favor of the defendants in the *McMahan* action, and dismissed the complaint. On April 10, 1990, the Court of Appeals reversed this decision. *See McMahan & Co. v. Wherehouse Entertainment, Inc.*, 900 F.2d 576 (2d Cir. 1990), *cert. denied*, 111 S. Ct. 2887 (1991).

Holdings, Inc. The merger was announced the following day. Debentureholders were given the opportunity to tender their securities at 50.72% of par.

Plaintiffs attempted to tender their Debentures to Wherehouse following this merger, seeking a redemption price of 106.25% pursuant to the "right to tender." Wherehouse refused to permit Plaintiffs to exercise this right because the board had approved the merger. Plaintiffs commenced their respective suits against the various defendants, including: Wherehouse, various officers of Wherehouse, Furman Selz Mager Dietz & Birney ("Furman Selz") as the underwriter of the Debentures, the merging companies, and the bank financing the offer (collectively, "Defendants").[2]

Plaintiffs claim that they were misinformed about the true nature of the right to tender debentures, that the right was illusory, and that the registration statements and the prospectus, as well as oral representations, were materially misleading. They allege that the right was portrayed as valuable to debentureholders, creating a duty to them on the part of the "Independent Directors," but that they were not informed that the right to tender would not be triggered by a friendly acquisition of Wherehouse. They allege federal securities claims arising under the following: Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k, for a misleading registration statement; Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 771, for a misleading prospectus or oral communication; and Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j, for fraud in connection with a sale of securities. In addition, they assert state-law claims based on breach of contract, interference with contract, breach of the implied duty of good faith, and fraudulent conveyance.

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[2] The defendant bank was dismissed without prejudice by stipulation and order filed July 29, 1991.

DISCUSSION

The Court will conduct a *de novo* review of the R & R and the parties' motions addressed therein. *See* 28 U.S.C. § 636(b)(1)(B); Fed. R. Civ. P. 72(b). A motion for summary judgment must be granted "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c). The facts are to be viewed favorably to the nonmoving party. *Adickes v. S. H. Kress & Co.*, 398 U.S. 144, 158-59 (1970). The moving party bears the burden of initially demonstrating the absence of a genuine issue of material fact. *Id.* at 159. This burden may be discharged as to issues on which the nonmoving party bears the ultimate burden by showing an absence of evidence in support of essential elements of that party's case. *Celotex Corp. v. Catrett*, 477 U.S. 317, 323-25 (1986). The nonmoving party must then come forward with "specific facts showing that there is a genuine issue for trial." Fed. R. Civ. P. 56(e); *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 256 (1986); *Celotex*, 477 U.S. at 324.

I. *The R & R.*

At the heart of Defendants' motion and the conclusion of the R & R is § 8.06 (the "No Action Clause") of the Indenture. The No Action Clause provides as follows:

> *Limitation on Suits.* A Securityholder may pursue any remedy with respect to this Indenture or the Securities only if:
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> (1) the Holder gives to the [Indenture] Trustee written notice of a continuing Event of Default;[3]

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[3] Section 8.01 of the Indenture states that an event of default occurs if, *inter alia*, "the Company defaults in the payment of the principal of any Security when the same becomes due and payable, whether at maturity, upon redemption or otherwise[, or] the Company fails to comply with any of its other agreements in the Securities or this Indenture."

> (2) the Holders of at least 25% in principal amount of the Securities make a written request to the Trustee to pursue the remedy;
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> (3) such Holder or Holders offer to the Trustee indemnity satisfactory to the Trustee against any loss, liability or expense;
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> (4) the Trustee does not comply with the request within 60 days after receipt of the request and the offer of indemnity; and
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> (5) during such 60-day period the Holders of a majority in principal amount of the Securities do not give the Trustee a direction inconsistent with the request.

Indenture, § 8.06. Section 14 of the Debentures states in relevant part. "Securityholders may not enforce the Indenture or the Securities except as provided in the Indenture."[4]

In a well-reasoned and thorough report, Magistrate Judge Roberts analyzed the law pertaining to "no action" provisions and applied this law to the instant No Action Clause. Magistrate Judge Roberts found the No Action Clause valid and enforceable as to both Plaintiffs' securities and non-securities claims. Because Plaintiffs failed to comply with the No Action Clause, she recommends that summary judgment be granted in Defendants' favor and that Plaintiffs' entire complaint be dismissed.

A. *Plaintiffs' Non-securities Claims.*

No action clauses are frequently included in indentures to limit the types of suits arising from those agreements. *See Upic & Co. v. Kinder-Care Learning Ctrs., Inc.*, 793 F. Supp.

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[4] As stated in § 8.07 of the Indenture, debentureholders are excused from complying with the No Action Clause in suits based on nonpayment of principal and interest on or after the due dates expressed in the Debenture and in suits based on the right to convert to Debenture to common stock. This is a requirement of § 316(b) of the Trust Indenture Act, 15 U.S.C. § 77ppp(b).

448, 454 (S.D.N.Y. 1992) (citing the American Bar Foundation, *Commentaries on Model Debenture Indenture Provisions*, 232-34 (1971)). "These clauses are strictly construed," *Cruden v. Bank of New York*, 957 F.2d 961, 968 (2d Cir. 1992), and have been enforced in a variety of contexts in both federal and state courts.

No action clauses have been used as a defense to the following types of debenture-related claims: civil claims brought under the Racketeer Influenced and Corrupt Organizations Act and fraudulent conveyance claims, *see Victor v. Riklis*, 91 Civ. 2897, 1992 WL 122911, at *6 (S.D.N.Y. May 15, 1992) (containing a "no action" clause identical in scope to the instant clause)[5]; actions to accelerate the time of payment on bonds, *see Friedman v. Chesapeake and Ohio Ry. Co.*, 261 F. Supp. 728, 730 (S.D.N.Y. 1966), *aff'd*, 395 F.2d 663 (2d Cir 1968), *cert. denied*, 393 U.S. 1016 (1969); actions to set aside transfers as violative of a trust indenture, *see Relmar Holding Co. v. Paramount Publix Corp.*, 263 N.Y.S. 776, 778 (1932), *aff'd*, 261 N.Y.S. 959 (1933); and actions based on nonpayment of coupons on debenture bonds, *see Greene v. New York United Hotels*, 260 N.Y.S 405, 407 (App. Div. 1 Dept. 1932), *aff'd*, 261 N.Y. 698 (1933) (securities held subject to the underlying trust agreement, which contained a no action clause). The Court will first determine whether the instant No Action Clause is a successful defense to Plaintiffs' state-law claims.

Plaintiffs contend that the No Action Clause does not apply to their situation because an absolute right to payment arose upon the occurrence of the merger. A no action clause, as stated in § 316(b) of the Trust Indenture Act, may not bar debentureholders from suing to enforce the payment of principal or interest "on or after the respective due dates expressed in [the debenture]." 15 U.S.C. § 77ppp(b); *see footnote 4*. Section 316(b) pertains to events of payment default where a company has failed to pay out on an indenture secu-

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[5] The "no action" clauses in *Victor* and the instant case are broad. They pertain to *any* remedy with respect to the Indenture or Debentures *See Victor*, at *7, n. 7.

rity after its maturity date or after an explicit date on which it has come due—in other words, when the right to payment becomes absolute and unconditional. *See Upic*, 793 F. Supp. at 455 (discussing legislative history of § 316(b)).[6]

The only date of payment explicitly stated in the Debenture on which the right to payment becomes unconditional is the maturity date, July 1, 2006. Plaintiffs do not seek to enforce payment on the Debentures on or after this date; therefore, § 316(b) is not applicable to the instant situation. Plaintiffs' right to tender prior to the due date expressed in the Debenture is analogous to an acceleration of payment of principal and interest, the time of which is not certain and, indeed, may never come. "[A]cceleration is a collection remedy provided in the Indenture and may not properly be considered a 'payment default.' " *Jackson Nat'l Life Ins. Co. v. Ladish Co.*, 92 Civ. 9358, 1993 WL 43373, at *6 (S.D.N.Y. 1993). This reasoning holds true for the conditional right to tender, which is subject to a decision by the "Independent Directors," prior to the Debentures' due date. The No Action Clause is not made inapplicable to this situation by means of § 316(b).

Plaintiffs contend that, even if it does pertain to their claims, the No Action Clause is unenforceable because it does not appear on the face of the Debentures. Magistrate Judge Roberts found no merit to this contention. This Court agrees. A restriction or condition upon security holders, such as the No Action Clause in the instant case, is enforceable when that restriction is "definite and fairly places the [securityholder] on notice that his [or her] rights to sue *before the stated maturity date* are restricted and conditioned by the indenture." *Friedman*, 261 F. Supp. at 730 n.1 (S.D.N.Y. 1966) (emphasis included) (citing *Dunham v. Omaha & Council Bluffs St. Ry. Co.*, 106 F.2d 1, 2 (2d Cir 1939), *cert. denied*, 309 U.S. 661 (1940)).

Friedman involved bonds which referred their holders to the underlying indenture for information on collection reme-

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[6] The securities in *Upic* became due and owing within a specific time period after a date certain and specified in the securities. *See Upic*, 793 F. Supp. at 450. Thus, § 316(b) applied in that situation *Id.* at 456.

dies prior to the bonds' maturity. Section 14 of the instant Debentures states that "[s]ecurityholders may not enforce . . . the Securities except as provided in the Indenture." Debenture, § 14. Just as in *Friedman*, Plaintiffs here, by the plain terms of the Debentures, are forced to rely on the Indenture to enforce their securities. The Indenture contains the No Action Clause which, in turn, refers back to the securities. The Debentures put the Plaintiffs on notice of the No Action Clause, a clause which limits suits for payment of principal and interest prior to maturity only, by referring Plaintiffs to the Indenture.[7]

Plaintiffs next argue that the "right to tender" is an individual right, and that the No Action Clause applies to the enforcement of "collective" rather than "individual" rights. This distinction is of no avail to Plaintiffs. Just as the "right to tender" refers to "The Holder" and "Each Holder," so too does the No Action Clause refer to "*A* securityholder['s]" pursuit of a remedy. *See supra.* Regardless of whether the language of these clauses refers to individual rights, the right to relief for a breach of an Indenture provision is limited by the broad No Action Clause. The Indenture states that a holder may pursue "any remedy with respect to [the] Indenture or the Securities only if: . . . (2) the Holders of at least 25% in principal amount of the Securities make a written request to the Trustee to pursue the remedy." Indenture, § 8.06(2), *supra*. Indentures contain such provisions

> to deter individual debentureholders from bringing independent law suits for unworthy or unjustifiable reasons, causing expense to the Company and diminishing its assets. The theory is that if the suit is worthwhile, 25% of the debentureholders would be willing to join in sponsoring it. The 25% figure is standard.

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[7] Magistrate Judge Roberts appropriately distinguished *Friedman v. Airlift Int'l, Inc.*, 355 N.Y.S 2d 613 (App. Div. 1 Dept. 1974), and *Cunningham v. Pressed Steel Car Co.*, 265 N.Y.S. 256 (App. Div. 1 Dept. 1933), *aff'd*, 263 N.Y. 671 (1934). While both cases addressed the effectiveness of restrictive language on the face of securities, both cases also involved the obligation to pay principal and interest *at maturity*.

Upic, 793 F. Supp. at 454 (citing American Bar Foundation, *Commentaries on Model Debenture Indenture Provisions*, *supra*). Regardless of whether the "right to tender" is characterized as a collective or individual right, it is does not escape application of the No Action Clause.[8]

As a last resort in objecting to the R & R, Plaintiffs seize upon the doctrines of laches and estoppel. They argue that Defendants should be precluded from using the No Action Clause as a defense because it was not raised in their original Rule 12(b)(6) motion to dismiss. *See* footnote 1, *supra.* Rule 12(h) of the Federal Rules of Civil Procedure addresses the "Waiver or Preservation of Certain Defenses." It is true that it may be more efficient to raise all defenses in one motion rather than in successive motions. However, while some defenses are waived if not raised at the first opportunity, such defenses do not include the defense of failure to state a claim upon which relief can be granted. *See* Fed. R. Civ. P. 12(g), (h)(2). The No Action Clause defense is such a defense and cannot be waived.

Finally, Magistrate Judge Roberts rejected Plaintiffs' argument "that they should not be bound by the no action provision because the *McMahan* plaintiffs held over 34 percent of the debentures when their complaint was filed. . . . Plaintiffs cite no authority for the novel proposition that a party to a contract should be excused from complying with a condition precedent merely because it was *capable* of compliance." *R & R*, pp. 14-15 Plaintiffs do not object to this conclusion.

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[8] Plaintiffs object to Magistrate Judge Roberts' finding that the right to tender appears to be a "collective right" since it effects all debentureholders in an identical manner. Plaintiffs argue that "the same could be said of non-payment of principal and interest." Objections to Magistrate's Report and Memorandum in Support of Summary Judgment, p. 17. This analogy is irrelevant to the finding of the Magistrate Judge. Because of a statutory exception to the No Action Clause, suits to enforce the payment of principal and interest after a debenture's maturity may be brought notwithstanding their characterization as "collective" or "individual." This very specific right was created not by this Court or by Magistrate Judge Roberts, but by the United States Congress. *See* footnote 4, *supra.*

Where no objections have been filed, the Court need only satisfy itself that there is no clear error on the face of the record before accepting the recommendation. *See Walker v. Hood*, 679 F. Supp. 372, 374 (S.D.N.Y. 1988); Fed. R. Civ. P. 72 advisory committee's note. The Court finds no clear error in this recommendation and adopts this portion of the R & R.

The Court has addressed all of Plaintiffs' objections to the R & R with regard to the state-based claims, and the Court agrees with Magistrate Judge Roberts' recommendations. The No Action Clause is broad and applies to "any remedy with respect to [the] Indenture or the Securities." Indenture, § 8.06. Plaintiffs did not comply with the No Action Clause, and thus are precluded from suing Defendants on the state-law claims. Summary judgment for Defendants is granted on these claims, and these claims are dismissed.

B. *Plaintiffs' Securities Claims.*

Magistrate Judge Roberts recommends not only that the state-law claims be dismissed, but that Plaintiffs' entire action be dismissed for failure to comply with the No Action Clause. Plaintiffs submit that clauses of this type cannot prevent federal securities claims. This Court agrees.

Plaintiffs rely heavily upon a statement by the Court of Appeals for the Third Circuit in *Kusner v. First Pennsylvania Corp.*, 531 F.2d 1234 (3d Cir 1976). That court found that the defendants there cited "no authority for the proposition that a 'no action' provision in an indenture effectively bars a direct action based upon the federal securities laws." *Id.* at 1239. However, unlike the broad clause in the instant case, the "no action" clause in that case prohibited only suits arising under the indenture. *Id.* While the impact of *Kusner* on the facts of the instant case is unclear, this Court does find that actions based on federal securities laws may not be precluded by a "no action" clause of any breadth.

Both the Securities Act of 1933 and the Securities Exchange Act of 1934 contain anti-waiver provisions. *See* Section 14 of the Securities Act, 15 U.S.C. § 77n; Section 29(a) of the Securities Exchange Act, 15 U.S.C. § 78cc. Both

Acts provide that "[a]ny condition, stipulation, or provision binding any person . . . to waive compliance" with the Acts "shall be void."

The No Action Clause here requires that holders of 25% of the Debentures must request initiation of a lawsuit by the Indenture Trustee; even then, that action is barred if a majority of the debentureholders instruct the Trustee not to sue. It is possible that a debentureholder could be forced to forego federal securities claims under the language of the No Action Clause. Indeed, this is what Defendants ask the Court to find. However, Sections 14 and 29(a) of the Securities Acts void provisions binding *any person* to waive compliance with the substantive protections of those Acts. They do not merely void provisions binding *plaintiffs* to a securities lawsuit to waive compliance with those protections. It is irrelevant that Plaintiffs did not attempt compliance with the No Action Clause prior to bringing federal securities suits, as the No Action Clause is void in this regard.

Defendants argue that the No Action Clause does not constitute a "waiver," but rather establishes a procedure which must be followed *before* an action may be brought. They attempt to analogize the No Action Clause to an arbitration clause, reaching the conclusion that both are "mere procedural limitation[s]."[9] Defendants' Response to Plaintiffs' Objections to Magistrate Judge's Report and Recommendation, p. 8. Defendants argue that a securities action by Plaintiffs was not precluded by the No Action Clause because they held over 25% of the Debentures at the time this action was commenced. Notwithstanding the truth of this statement, the No Action Clause is impotent with regard to any federal securities claims. If any securityholder is forced to forego his or her rights under the federal securities laws due to a contract provision, then that provision is void. Plaintiffs appropriately

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[9] Arbitration clauses are enforceable under federal securities laws. *See Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 485-86 (1989); *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 238 (1987). Arbitration clauses were held to be procedural provisions, and not within the ambit of §§ 14 and 29(a).

reject Defendants' analogy, arguing that "[i]t is difficult to imagine a starker distinction than that between a forum clause, which only controls *where* a claim is brought, and a clause which actually *bars* many claims." Plaintiffs' Objections, p. 20.

This Court holds that, as a matter of law, "no action" clauses in indentures or securities may not be used as a defense to federal securities claims. The No Action Clause in question does not preclude Plaintiffs' federal claims. Defendants' motion for summary judgment on this issue is denied.

II. *Alternative Grounds for Summary Judgment.*[10]

A. *Plaintiffs' Motion for Summary Judgment.*

Plaintiffs have moved for summary judgment on the breach of contract and breach of the implied covenant of good faith claims. As stated in Section I(A) of this Opinion, *supra*, these claims are dismissed due to Plaintiffs' failure to comply with the No Action Clause. Plaintiffs' motion for summary judgment is dismissed as moot.

B. D*efendants' Motion for Summary Judgment.*

Defendants contend that several more grounds exist which warrant the entry of summary judgment in their favor. Before addressing these contentions, the Court stresses that there are numerous issues of material fact potentially making summary judgment inappropriate. Many of these issues are genuine and in need of resolution by the finders-of-fact. *See McMahan & Co. v. Wherehouse Entertainment Inc.*, 900 F.2d 576 (2d Cir. 1990), *cert. denied*, 111 S. Ct. 2887 (1991).

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[10] The remaining issues were not addressed in the R & R, which relied on the No Action Clause in reaching its conclusion.

1. *Summary Judgment As to All Plaintiffs.*

Defendants contend that they have not, as a matter of law, caused Plaintiffs to suffer damages under §§ 11 and 10 of the Securities Acts because losses in the value of the Debentures were not caused by the alleged misrepresentations in the Prospectus. Defendants state that the market value per Debenture was $1,000 when issued in July of 1986 and only $470 on the business day prior to December 21, 1987—the day the Wherehouse board of directors announced approval of the merger. Plaintiffs counter that they do not seek damages based on decline in market value, but upon their inability to exercise their right to tender at the time of Wherehouse's merger.

a. *Section 11 Damages.*

Damages under § 11 are measured by the difference between the amount paid for the security and the value of that security at the time suit is brought. 15 U.S.C. § 77k(e). Damages under § 11 are capped at the price at which the security was offered to the public. 15 U.S.C. § 77k(g). Defendants may prove that any portion of a plaintiff's losses are due to a depreciation in value not resulting from the alleged misrepresentation. 15 U.S.C. § 77k(e). Thus, Defendants may show "negative causation" in order to escape liability, while Plaintiffs must show a decrease in value due to fraud.

Plaintiffs claim that Defendants misrepresented in the registration materials the true nature of the debentureholders' right to tender. "[N]otwithstanding the broad discretion which issuers have in assembling and organizing their data, where the method of presentation obscures or distorts the significance of material facts, a violation of Section 11 will be found." *Greenapple v. Detroit Edison Co.*, 618 F.2d 198, 205 (2d Cir. 1980) (citing cases). Defendants argue that any alleged § 11 violations did not impact upon the low market value of the Debentures at the time of merger, and that they therefore cannot be held responsible for this depreciation.

Under the very specific facts of this case, a showing of "negative causation" based upon market value is of no defense to Defendants. It is true that a "price decline before

disclosure may not be charged to defendants." *Akerman v. Oryx Communications, Inc.*, 810 F.2d 336, 342 (2d Cir. 1987) (citing cases). However, Plaintiffs do not seek to hold Defendants liable for this market-decline. Acceptance of Defendants' argument would make § 11 toothless: misrepresentation as to value to be received would be proscribed, but securityholders would be powerless to enforce this prescription.

Plaintiffs seek damages based on the promised value that was lost due to alleged fraud. Plaintiffs attempted to redeem the Debentures at a premium pursuant to the "right to tender." Instead, Plaintiffs received a reduced amount due to the alleged fraud of Defendants with respect to this right. The market is irrelevant to Plaintiffs' claimed economic losses. Obviously, the real market value of the Debentures is less than the premium to which Plaintiffs claim entitlement. Plaintiffs are permitted to seek damages based upon the alleged violation of § 11 of the Securities Act.

b. *Section 10 Damages.*

Defendants argue that Plaintiffs have suffered no legally cognizable damages under § 10 of the Securities Exchange Act. Section 10(b) requires that plaintiffs prove "loss causation"—a loss in the value of an investment *caused* by defendants' fraud. *Manufacturers Hanover Trust Co. v. Drysdale Securities Corp.*, 801 F.2d 13, 20 (2d Cir. 1986), *cert. denied*, 479 U.S. 1066 (1987). Again, Defendants argue that any loss in the value of the Debentures is attributable to the market, and that Plaintiffs are not entitled to "benefit-of-the-bargain damages" based upon the value the Debentures were allegedly represented to have.

Plaintiffs correctly argue that they may be compensated "for economic loss suffered as a result of wrongs committed in violation of the 1934 Act, whether the measure of those compensatory damages be out-of-pocket loss, the benefit of the bargain, or some other appropriate standard." *Osofsky v. Zipf*, 645 F.2d 107, 111 (2d Cir. 1981). *Osofsky* involved misrepresentations in a tender offer to shareholders as to the value of consideration they would receive in a merger. The

Court of Appeals found that the shareholders should receive the amount which they were told they would receive. *Id.* at 113. The Court established the proper rule to be as follows:

> [T]he benefit-of-the-bargain rule should be applied under the 1934 Act to the limited situation involved in [that] case, where misrepresentation is made in the tender offer and proxy solicitation materials as to the consideration to be forthcoming upon an intended merger. . . . [G]iving the plaintiff benefit-of-the-bargain damages is appropriate only when they can be established with reasonable certainty.

Id. at 114.

The situation in *Osofsky* is not unlike the situation in the instant action. Plaintiffs allege that Defendants made misrepresentations involving their right to tender back Debentures to Wherehouse upon the occurrence of a merger. Under this alleged scenario, Plaintiffs are tantamount to "sellers" of securities who have been promised a specific consideration for their holdings. They claim that they were promised a sum certain upon tendering their securities, but instead they received a lesser amount than promised. Plaintiffs, if they prove their case, are entitled to benefit-of-the-bargain damages, which here can be established with certainty. In other words, Plaintiffs are entitled to the difference between what they were told they would receive and what they actually received, independent of market value. Defendants argue that the rule of *Osofsky* is one of limited application which should not be applied to "buyers" of securities. They further argue that damages do not become awardable simply because they can be calculated with precision. In support they cite to *Levine v. Seilon, Inc.*, 439 F.2d 328 (2d Cir. 1971), and *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973), for the proposition that benefit-of-the-bargain damages are available only to defrauded sellers, and not to buyers.[11] While it is true that these two cases

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[11] Defendants also cite *Freschi v. Grand Coal Venture*, 767 F.2d 1041, 1051 (2d Cir. 1985), *vacated*, 478 U.S. 1015 (1986), as a recent

do state this, the court in *Osofsky* points out that this was stated in dictum. 645 F.2d at 112, 113.

The distinction between buyers, whose gain is "speculative," and sellers, who are promised a specific price, "lies in the ability to determine the amount of damages with certainty." *Osofsky*, 645 F.2d at 112. *See also Commercial Union Assurance Co. v. Milken*, 17 F.3d 608, 614-15 (2d Cir. 1994) (denying benefit-of-the-bargain damages to buyers of partnership interests only because of the absence of a "reasonable certainty" as to what they "would have earned"); *Barrows v. Forest Lab., Inc.*, 742 F.2d 54, 59 (2d Cir. 1984) (reading *Osofsky* for the proposition that benefit-of-the-bargain damages are unavailable to buyers only where their determination is "unduly" speculative). Plaintiffs, like sellers, were allegedly falsely promised specific consideration for their holdings upon the occurrence of a merger. The rule of *Osofsky* applies perfectly to this situation.

Court of Appeals opinion standing for the proposition that "a Rule 10b-5 plaintiff can be compensated only for actual damages." The plaintiff in that case was promised tax deductions arising from a tax shelter. When deductions were disallowed, the plaintiff sued under Rule 10b-5. The District Court denied benefit-of-the-bargain damages. 588 F. Supp. 1257, 1259. The Court of Appeals affirmed finding that "any award in compensation for hoped-for tax savings would be an impermissible award of damages arising from an expectation interest." 767 F.2d at 1051. The Supreme Court vacated and remanded that decision in light of *Randall v. Loftsgaarden*, 478 U.S. 647 (1986) and *Sedima S.P.R.L. v. Imrex Co., Inc.*, 473 U.S. 479 (1985). The Court in *Randall* found that Congress did not define the extent of the "actual damage" which may be recovered under the 1934 Act, 15 U.S.C. § 78bb(a), and that these "flexible" damages are not limited to the net economic harm suffered by a plaintiff. 478 U.S. at 663. The plaintiff in *Randall* was permitted to receive damages unreduced by tax benefits received.

On remand of *Freschi*, the Court of Appeals did not expressly reverse its decision that "hoped-for" value is not recoverable. 800 F.2d 305. However, the earlier decision by the Court of Appeals was *vacated* by the Supreme Court and is of no value to Defendants. The entire rule and reasoning of *Freschi* is in doubt. *Randall* teaches that "actual damages" greater than those permitted in *Freschi* may be recovered.

c. *Scienter under § 10-b.*

Defendants next contend that they cannot be held liable under § 10(b) because there is no evidence of scienter on their part. Scienter is one of the requirements for liability under § 10(b) and can be established by a showing of intent or recklessness by a defendant. *Royal Am. Managers, Inc. v. IRC Holding Corp.*, 885 F.2d 1011, 1015 (2d Cir. 1989). "Issues of motive and intent are usually inappropriate for disposition on summary judgment. . . . In a § 10(b) action, a court may not grant such relief to the defendants on the ground of lack of scienter unless the plaintiff has failed to present facts that can support an inference of bad faith or an inference that defendants acted with an intent to deceive." *Wechsler v. Steinberg*, 733 F.2d 1054, 1058 (2d Cir. 1984).

Defendants put forth evidence, especially by way of deposition testimony, to demonstrate this lack of scienter. They submit evidence as to the good faith of Wherehouse's directors and the lack of involvement of outside directors in the issuance of the Debentures. While there is certainly evidence in support of Defendants' case, this Court finds that there is also sufficient evidence in support of Plaintiffs' case from which a jury could infer scienter. The offering materials could be found ambiguous with regard to the "right to tender" and misleading with regard to the Debentures' true value. *See McMahan v. Wherehouse Entertainment Inc.*, 900 F.2d 576, 581 (2d Cir. 1990), *cert. denied*, 111 S. Ct. 2887 (1991). This could be found to be the result of intentional misconduct or recklessness by Defendants. Plaintiffs have presented evidence supportable of an inference of bad faith, and it will be for a jury to decide this issue.

2. *Summary Judgment As to Froley, Revy Investment Co., Inc.*

In their original motion, Defendants raise additional grounds for the entry of summary judgment against plaintiff Froley, Revy Investment Co., Inc. ("Froley, Revy"), a party to the *McMahan* portion of this action. These grounds shall be addressed separately.

a. *Section 10(b) "transaction causation."*

Defendants first contend that they should be granted summary judgment on Froley, Revy's § 10(b) claim because Froley, Revy cannot prove "transaction causation." Like "loss" causation, "transaction" causation must be established before liability can be found under § 10(b). *Burke v. Jacoby*, 981 F.2d 1372, 1378 (2d Cir. 1992), *cert. denied*, 113 S. Ct. 2338 (1993). "Transaction causation focuses on whether the alleged fraud *induced* the plaintiff to buy the security," and "can be thought of as 'but for' causation, or reliance." *Perez-Rubio v. Wycoff*, 718 F. Supp. 217, 238-39 (S.D.N.Y. 1989) (emphasis added).

Again, both sides put forth evidence in their support. Defendants give evidence that Froley, Revy based its investment decision on factors other than the "right to tender." However, Froley, Revy gives evidence that the right to tender was "one of the inducements" in deciding to purchase the Debentures and "of some value." September 23, 1992 Deposition of Thomas Revy, pp. 65, 110. Thomas Revy, of Froley, Revy, has also described the right as "important" and stated that he purchased the Debentures based on oral and written representations, apparently regarding the right to tender. March 7, 1988 Affidavit of Thomas Revy, p. 3. Sufficient evidence exists for a jury to infer that Froley, Revy relied on the alleged misrepresentation when purchasing the Debentures. *See Burke*, 981 F.2d at 1378-79. Summary judgment on this ground is denied.

b. *Timeliness of Froley, Revy's § 12(2) Claim.*

Defendants next contend that the statute of limitations under § 12(2) bars Froley, Revy's claim. "No action shall be maintained to enforce any liability created under [§ 12(2)] unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence." 15 U.S.C. § 77m. Froley, Revy commenced this action in January of 1988, the month following the Wherehouse merger which allegedly should have triggered the "right

to tender." The § 12(2) claim was added approximately five months later. Oral representations regarding the "right to tender" were allegedly made by a representative of Furman Selz Mager Dietz & Birney Inc. ("Furman Selz"), underwriter of the Debentures, to Thomas Revy in the summer of 1986, eighteen months before the commencement of this action. Defendants maintain that the Prospectus, which was also read at that time, contradicts these alleged statements. Therefore, Defendants argue that Froley, Revy was placed on notice of the alleged § 12(2) violation prior to one year before the action was commenced.

Defendants admit that reasonable diligence is the standard by which the commencement of the statute of limitations is determined "[O]n a fair reading of the offering materials . . . an investor could have reasonably believed that the tender option was presented as a valuable right for debentureholders." *McMahan*, 900 F.2d at 581. The alleged misstatements, as claimed by Froley, Revy in its Amended Complaint, are consistent with this fair reading. *Id.* A reasonable investor, exercising "reasonable diligence," cannot be deemed to be on notice of a § 12(2) violation under these circumstances. Froley, Revy's § 12(2) claim was brought well within the time it should have been discovered.

c. *Defendants as "Sellers" of Debentures.*

Wherehouse argues that it cannot be held liable as a "seller" of the Debentures. Liability under § 12(2) is limited to those who offer or sell securities by means of a materially misleading prospectus or oral communication. 15 U.S.C. § 771(2). "[T]he term 'seller' must include the person 'who successfully solicits the purchase, motivated at least in part by a desire to serve his [or her] own financial interests or those of the securities owner.' " *Capri v. Murphy*, 856 F.2d 473, 478 (2d Cir. 1988) (quoting *Pinter v. Dahl*, 486 U.S. 622, 647 (1988)).[12] Wherehouse claims that Furman Selz, as under-

[12] *Pinter* is concerned with § 12(1) of the Securities Act. This case has been held to be applicable to § 12(2), as well. *See Capri*, 856 F.2d at 478.

writer, passed title to the holders of the securities and that therefcre no other Defendant can be deemed the seller of the Debentures for the purposes of § 12(2) liability. They argue that no oral misrepresentations were made by anyone from Wherehouse and that the "Independent Directors" played no role in the marketing of the Debentures.

The Supreme Court stated in *Pinter* that despite the existence of courts and commentators who would restrict § 12 liability to those who transfer title of securities for value it does not read that statute "so restrictively." 486 U.S. at 644. Plaintiffs point out that when the promoter of securities acts at the "behest" of another party and upon information "supplied" by that party, then the second party may be found to be a "seller" under § 12(2). *See Capri*, 856 F.2d at 478. Title to a security does pass from the issuer to the underwriter, and then from the underwriter to the buyer. *Akerman*, 810 F.2d at 344. Thus, there is no privity between the issuer and the buyer. *Id.* However, if the plaintiff-buyer puts forth proof of scienter, "a person who makes a misrepresentation may be held liable as a 'participant' even though he [or she] is not the immediate and direct seller of the securities." *Id.* (citing *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1298-99 (2d Cir. 1973)). "Liability under section 12(2) is available to the buyer of securities against his [or her] immediate seller, and against those who 'substantially participated' in the sale." *In re CitiSource, Inc. Sec. Litig.*, 694 F. Supp. 1069, 1083 (S.D.N.Y. 1988) (postdating *Pinter*).

The position of the courts of this circuit and the Supreme Court is contrary to Defendants' position. There need be no direct contact between a plaintiff and defendant, provided that the defendant, with scienter, participated in the sale of securities. Froley, Revy has established a connection between defendant Louis Kwiker, Chief Executive Officer and chairman of the board of Wherehouse, and Furman, Selz in the solicitation of the Debentures. There is no dispute that "Mr. Kwiker participated in the solicitation process." Defendants' Memorandum in Support of Summary Judgment, p. 35. Only the extent of that participation is in dispute. Froley, Revy's

evidence is supportable of an inference that Wherehouse and its directors, motivated by financial interests, participated, with scienter, in the sale of the Debentures. While Plaintiffs' evidence may not conclusively establish § 12(2) liability by Wherehouse or Louis Kwiker, Defendants' evidence does not conclusively establish otherwise. Plaintiffs will be given the opportunity to present a case that Furman, Selz acted at the behest of Wherehouse in misrepresenting the value of Debentures and the "right to tender" and in selling the Debentures. Defendants may be found to be sellers of the Debentures

d. *Application of § 12(2) to Froley, Revy's Aftermarket Purchase.*

Defendants contend that Froley, Revy's debenture purchases which occurred after the initial public offering (and after the market price of the Debentures had fallen) should be excluded from the § 12(2) claim as a matter of law. In support, they cite to *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 693 (3d Cir.), *cert. denied*, 112 S. Ct. 79 (1991), in which the Court of Appeals for the Third Circuit held that § 12(2) applies only to initial offerings of securities and not to aftermarket trading. This rule has had support in this circuit. *See, e.g., Strong v. Paine Webber, Inc.*, 700 F. Supp. 4, 5 (S.D.N.Y. 1988); *SSH Co., Ltd. v. Shearson Lehman Bros. Inc.*, 678 F. Supp. 1055, 1059 (S.D.N.Y. 1987). However, there is a contrary view that § 12(2) does apply to aftermarket transactions. *See, e.g., Pacific Dunlop Holdings Inc. v. Allen & Co. Inc.*, 993 F.2d 578, 582 (7th Cir. 1993); *Farley v. Baird, Patrick & Co. Inc.*, 750 F. Supp. 1209, 1221 (S.D.N.Y. 1990).

Plaintiffs argue that the Court should accept the more expansive view of the applicability of § 12(2). However, it also argues that the Court need not reach this decision at all, and that the Court instead may apply § 12(2) to aftermarket purchases bearing a close relationship to the initial offering. This Court agrees. To establish liability under § 12(2), a plaintiff must have purchased securities pursuant to a false or misleading prospectus. *In re AES Corp. Sec. Litig.*, 825 F. Supp. 578, 592 (S.D.N.Y. 1993) (citing cases). While this pur-

chase is often during the initial offering, claims "may be brought by persons who purchased shares 'traceable' to the public offering." *Id.* (relying upon *Barnes v. Osofsky*, 373 F.2d 269, 272 (2d Cir. 1967) (stating in dictum that application of § 12(2) is not limited to newly registered securities)).

Where there is no nexus between the aftermarket transactions and a public offering, the weight of authority is clearly that § 12(2) should not be applied to the aftermarket purchases. This is not the instant case. Here, Froley, Revy purchased approximately one-half of its Debentures in the initial securities offering. It can be reasonably inferred that the decision to purchase in the aftermarket was based on information received at the time of the initial purchase, such as from a prospectus or an oral communication. Froley, Revy claims to have made the secondary purchases to reduce the average cost of the initial investment. Defendants do not refute this connection, but instead urge the Court to adopt the blanket-rule that § 12(2) does not apply to aftermarket transactions. The Court rejects this argument and follows the reasoning of *In re AES Corp.* Given the nexus between the initial purchases and the aftermarket purchases, § 12(2) will be applied to all of Froley, Revy's Debentures.[13]

3. *As to the Thompson Class.*

Finally, Defendants argue that the claims brought pursuant to § 11 of the Securities Act by Don Thompson ("Thompson") are barred as untimely. The statute of limitations on § 11 claims is the same as that for § 12(2) claims. *See* Section II(2)(b) of this Opinion, *supra*. Section 13 of the Securities Act provides in relevant part: "No action shall be maintained to enforce any liability created under [§ 11] unless brought

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[13] Defendants make a final argument in their reply papers that neither Wherehouse nor Furman Selz were the sellers of the securities purchased in the aftermarket. While the defense that Wherehouse is not a "seller" was addressed in section II(2)(c) of this Opinion, *supra*, this specific argument relating to after-market purchases was not raised earlier. The Court expresses no opinion as to the merit of this argument. Instead, the Court declines to address the issue as it is inappropriately raised at this juncture. *See In re AES*, 825 F. Supp. at 593, n. 20.

within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence." 15 U.S.C. § 77m. Suit must be filed within one year after the time a plaintiff is in possession of facts objectively sufficient to have placed that plaintiff on inquiry notice of a potential claim. *Bresson v. Thomson McKinnon Sec., Inc.*, 641 F. Supp. 338, 344 (S.D.N.Y. 1986) (citing *Ingenito v. Bermec Corp.*, 441 F. Supp. 525, 554 (S.D.N.Y. 1977)). Defendants contend that Thompson was on inquiry notice of the facts surrounding his claim more than one year prior to the commencement of his action.

Defendants must meet an extraordinary burden in convincing the Court that summary judgment based on inquiry notice is appropriate. Whether reasonable diligence was exercised by a party is a ordinarily a question of fact for a jury. *In re Integrated Resources Real Estate Ltd. Partnerships Sec. Litig.*, 815 F. Supp. 620, 638 (S.D.N.Y. 1993). " 'When conflicting inferences can be drawn from the facts, . . . summary judgment is inappropriate.' " *Id.* (quoting *Robertson v. Seidman & Seidman*, 609 F.2d 583, 591 (2d Cir. 1979)). "[I]t is only in 'extreme circumstances' that summary judgment is appropriate when the defendants assert that the action was untimely commenced because inquiry notice was triggered more than a year before the action was brought by the plaintiff." *Integrated Resources*, 815 F. Supp. at 638 (quoting *Freschi v. Grand Coal Venture*, 583 F. Supp. 780, 785 (S.D.N.Y. 1984)). The Court will examine Defendants' motion with these considerations.

Thompson filed this action on December 21, 1988, just within the one year limitations period which began to run upon the announcement by Wherehouse of the merger. Defendants contend that Thompson was on notice of the nature of the "right to tender" on November 19, 1987, when Shamrock announced in a press release that it would make a tender offer for Wherehouse.[14] In that release, Shamrock's president and

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[14] The merger which allegedly triggered the right to tender followed this offer by Shamrock. *See* Background, *supra*.

chief executive officer announced that in the absence of a merger agreement debentureholders would have the right to redeem their debentures at a premium, but if a proposed merger agreement were executed, this right of redemption would not be triggered. The information contained in the release was published on November 20, 1987 in the *Wall Street Journal*, *Los Angeles Times*, Business Wire, and Reuters. Defendants contend that this announcement should have put Thompson on inquiry notice that his understanding of the nature of the "right to tender," as it relates to friendly acquisitions, might not be accurate.[15]

Again, § 11 provides for civil liability on account of a false registration statement. Plaintiffs contend that the registration statement misstated the right to tender. The Court of Appeals found that a rational trier of fact could view the registration materials as misleading. *McMahan*, 900 F.2d at 581. On a "fair reading" of the registration materials, a reasonable investor could have believed that "Independent Directors were to render independent votes on the right to tender based on the impact of a merger and on the interests of debentureholders." *Id.* Clearly, reasonable minds can differ as to the nature of the "right to tender."

Shamrock's conclusions regarding this right were made independently of any specific information provided by Wherehouse other than in the registration materials and Prospectus. It would be unfair to deem Thompson on inquiry notice based upon the subjective conclusions of a third party about the effect of a potentially ambiguous right.[16] This Court

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[15] Publication of information in the media gives plaintiffs constructive knowledge of that information. *In re Integrated Resources*, 815 F. Supp. at 639. Additionally, Shamrock filed a lawsuit in California State Court on November 19, 1987, alleging that the Debentures constituted "poison debt" giving the Independent Directors "unbridled discretion" in determining whether the right to tender has been triggered. Defendants argue that this lawsuit also put Thompson on notice. *See Id.*; *Korwek v. Hunt*, 646 F. Supp. 953, 958 (S.D.N.Y. 1986), *aff'd*, 827 F.2d 874 (2d Cir. 1987) (citing *Berry Petroleum Co. v. Adams & Peck*, 518 F.2d 402, 410 (2d Cir. 1975)).

[16] Shamrock's press release does indicate a view of the right to tender different from that expressed by Plaintiffs, it appears that

is reluctant to deem Thompson on notice of the true nature of the "right to tender" when that notice would have come from the subjective views of a third party. Defendants' motion for summary judgment against Thompson based on the statute of limitations is denied.

CONCLUSION

For the reasons stated above, the Court adopts in part and declines to adopt in part the Magistrate Judge's Report and Recommendation. Plaintiffs' motion for partial summary judgment is dismissed as moot. Defendants' motion for summary judgment on the claims arising under state law is granted. Defendants' motion for summary judgment on the federal securities claims is denied. A Joint Pre-trial Order is due on or before October 14, 1994.

It is SO ORDERED.

Dated: New York, New York
August __, 1994

MARY JOHNSON LOWE
United States District Judge

Shamrock too was unsure of the effect of that right to tender. On November 19, 1987, Shamrock sued Wherehouse and its directors in California state court alleging that the Debentures constitute "poison debt." Defendants' Memorandum in Support, p. 42 n. 87. Shamrock alleged that "[t]he Indenture leaves unbridled discretion to the Independent Directors in determining whether a Triggering Event is to be approved." *Id.*

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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88 Civ. 0321 (MJL) (KAR)

MCMAHAN & COMPANY, FROLEY, REVY INVESTMENT CO. INC. and WECHSLER & KRUMHOLZ, INC.,

Plaintiffs,

—against—

WHEREHOUSE ENTERTAINMENT, INC., LOUIS A. KWIKER, GEORGE A. SMITH, MICHAEL T. O'KANE, LAWRENCE K. HARRIS, DONALD E. MARTIN, JOEL D. TAUBER, FURMAN SELZ MAGER DIETZ & BIRNEY INCORPORATED. WEI ACQUISITION CORP., WEI HOLDINGS, INC. and ADLER & SHAYKIN,

Defendants.

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88 Civ. 9040 (MJL) (KAR)

DON THOMPSON, on behalf of himself and all others similarly situated,

Plaintiff,

—against—

WHEREHOUSE ENTERTAINMENT, INC., LOUIS A. KWIKER, GEORGE A. SMITH, MICHAEL T. O'KANE, LAWRENCE K. HARRIS, DONALD E. MARTIN, JOEL D. TAUBER, and FURMAN SELZ MAGER DIETZ & BIRNEY INCORPORATED,

Defendants.

REPORT & RECOMMENDATION

TO THE HONORABLE MARY JOHNSON LOWE:

This Report and Recommendation addresses a motion for partial summary judgment filed by plaintiffs in *McMahan* and *Thompson* on June 17, 1993, and defendants' motion for summary judgment dismissing both complaints, also filed on June 17, 1993. For the reasons set forth below, I recommend that the defendants' motion for summary judgment be granted and the above-captioned complaints be dismissed.

BACKGROUND

Plaintiffs commenced these actions on January 15, 1988 (*McMahan*),[1] and December 21, 1988 (*Thompson*), alleging breach of contract and violations of the federal securities laws in connection with the sale of convertible subordinated debentures (the "Debentures") issued in July 1986 by defendant Wherehouse Entertainment, Inc. ("Wherehouse").[2] Defendant Furman Selz Mager Dietz & Birney, Inc. ("Furman Selz") served as underwriter for the Debentures. At issue in both cases is a provision contained on the face of the Debentures, in the governing Indenture and in the Prospectus,[3] which provided that if a "triggering event" occurred, the debentureholders would have the right to sell their debentures back to Wherehouse at the set redemption price of 106.25% of par value:

> *Holder's Right to Tender.* The Holder of any Security or Securities shall have the right, at his option, upon giving

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[1] An amended complaint was filed by the *McMahan* plaintiffs on January 22, 1988, and a "Revised Amended Complaint" was filed on June 14, 1988.

[2] The *McMahan* Plaintiffs are financial institutions that purchased the Debentures; the *Thompson* plaintiffs are individual investors who purchased the Debentures. *Thompson* has been certified as a class action.

[3] Defendants' Appendix ("Def. App.") contains a copy of the Indenture (Ex. 1), and a copy of the Prospectus (Ex. 2). The Debenture is annexed to the Indenture as Exhibit A.

> of notice of the occurrence of any event described in Section 5.02 * * * to tender for redemption any such Security or Securities * * *.

Indenture § 5.01.

Section 5.02 of the Indenture sets forth the events referred to in § 5.01:

> (a) A person or group * * * shall attain the beneficial ownership * * * of an equity interest representing at least 80% of the voting power for election of the Board of Directors of the Company unless such attainment has been approved by a majority of the Independent Directors;
>
> (b) The Company * * * consolidates or merges with any other person * * * unless approved by a majority of the Independent Directors;
>
> (c) The Company or any Subsidiary incurs, issues, assumes, guarantees or creates any Debt, or pledges any Company or Subsidiary assets to secure repayment of any Debt, excluding Debt existing on July 9, 1986 and Debt which is authorized or ratified by a majority of the Independent Directors * * *.

Indenture § 5.02

On December 20, 1987, Wherehouse entered in a merger agreement with defendant WEI Holdings, Inc. ("WEI"),[4] owned by defendant Adler & Shaykin, a New York Partnership.[5] The Independent Directors[6] of Wherehouse (defendants

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[4] WEI Holdings, Inc., is a Delaware corporation with its principal place of business in New York City. Defendant WEI Acquisition Corp., a Delaware corporation with its principal place of business in New York City, is a subsidiary of WEI Holdings, Inc. Louis A. Kwiker was Wherehouse's Chief Executive Officer, President and Director.

[5] This merger was in response to a hostile takeover effort by Shamrock Holding, Inc.

[6] The term Independent Directors is defined in § 5.02 of the Indenture as a director who had not been an employee of the company during the preceding 5 years.

George Smith, Michael O'Kane, Lawrence Harris, Donald Martin, and Joel Tauber) unanimously voted in favor of the merger; Wherehouse and WEI therefore took the position that there was no "triggering event" under § 5.02.[7]

Plaintiffs contend that the Indenture prohibits the Independent Directors from approving any merger that is not in the debentureholders' interest, and that the Independent Directors breached the Indenture contract by unanimously approving the merger with WEI. Alternatively, plaintiffs contend that if the Indenture did not protect debentureholders in this manner, defendants violated federal securities laws by issuing debentures pursuant to a materially misleading registration statement and prospectus and by omitting to state in the registration statement and prospectus that the "holder's right to tender" was not for the benefit of the debentureholders. Defendants contend that the Indenture provides for redemption of the Debentures at a premium only in the event of a merger that was not approved by a majority of the Independent Directors, *i.e.*, a hostile takeover. Accordingly, defendants contend that since the merger with WEI was unanimously approved by the Independent Directors, the "holder's right to tender" was not activated.

PROCEDURAL HISTORY

The *McMahan* case was referred to me for supervision of pretrial discovery on February 2, 1988 and for all substantive motions on March 21, 1988. On February 23, 1988, defendants moved to dismiss the *McMahan* amended complaint pursuant to Rules 12(b)(1) and 12(b)(6) of the Federal Rules of Civil Procedure. On August 10, 1988, after having advised the parties in *McMahan* of my intention to treat defendants' motion to dismiss as a summary judgment motion, I recommended that the complaint be dismissed, on the ground that there were no genuine issues of material fact with respect to

[7] The debentureholders were given an opportunity to redeem their debentures at 50.72% of par value. The most recent closing price had been 47% of par.

plaintiffs federal securities claims, and that defendants were entitled to judgment as a matter of law on those claims. I further recommended that the pendent state law claims be dismissed. Your Honor adopted my Report and Recommendation by Opinion and Order dated May, 25, 1989.

Plaintiffs appealed, and on April 10, 1989, the Court of Appeals reversed and remanded for further proceedings, on the ground that summary judgment on plaintiffs' securities claims was precluded by the existence of material issues of fact as to whether written and oral representations about the right to tender provision were material and misleading to a reasonable investor. *McMahan & Company v. Wherehouse Entertainment, Inc.*, 900 F.2d 576 (2d Cir. 1990), *cert. denied*, ___ U.S. ___, 111 S.Ct. 2887 (1991). The *Thompson* case was referred to me on June 20, 1991.

DEFENDANTS' MOTION FOR SUMMARY JUDGMENT

"No Action" Clause

Defendants move to dismiss the *McMahan* and *Thompson* complaints, *inter alia*, on the ground that plaintiffs have failed to comply with § 8.06 of the Indenture (the "no action" provision).[8] Section 8.06 provides:

> *Limitation on Suits.* A Securityholder may pursue any remedy with respect to this Indenture of the Securities only if:
>
> (1) the Holder gives to the Trustee written notice of a continuing Event of Default;[9]

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[8] Because I find that these actions are barred by plaintiffs' failure to comply with the no action provision, I do not address the other grounds for dismissal asserted by defendants or plaintiffs' motion for summary judgment.

[9] Under § 8.01(3) of the Indenture an "event of default" occurs, *inter alia*, if "the Company fails to comply with any of its other agreements in the Securities or this Indenture * * *."

(2) the Holders of at least 25% in principal amount of the Securities make a written request to the Trustee to pursue the remedy;

(3) such Holder or Holders offer to the Trustee indemnity satisfactory to the Trustee against any loss, liability or expense;

(4) the Trustee does not comply with the request within 60 days after receipt of the request and the offer of indemnity; and

(5) during such 60-day period the Holders of a majority in principal amount of the Securities do not give the Trustee a direction inconsistent with the request.

Indenture § 8.06. This provision does not appear on the face of the Debentures. However, § 14 of the Debenture states that

> Securityholders may not enforce the Indenture or the Securities except as provided in the Indenture. The Trustee may require indemnity satisfactory to it before it enforces the Indenture or the Securities.

Debenture § 14.

Under § 8.07 of the Indenture, debentureholders are excused from complying with the no action provision 1) with respect to suit based upon the nonpayment of principal and interest "on or after the respective due dates expressed in the [Debenture],"[10] and 2) with respect to suit based on the debentureholder's right to convert the Debenture to common stock.

The Second Circuit has held that no action clauses are to be "strictly construed." *Cruden v. Bank of New York*, 957 F.2d 961, 968 (2d Cir. 1992),[11] and provisions comparable to § 806

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[10] This provision is required by § 316(b) of the Trust Indenture Act, 15 U.S.C. § 77ppp(b). *See Cruden v. Bank of New York*, 957 F.2d 961, 968 (2d Cir. 1992).

[11] The *Cruden* court observed that permitting circumvention of no action clauses would "upset[ ] settled indenture law and the expectations of countless parties to proposed or existing indenture agreements." *Cruden*, 957 F.2d at 969.

of the Wherehouse Indenture have been enforced by both federal and state courts. *See, e.g., Victor v. Riklis*, 91 Civ. 2897 (LJF), 1992 WL 122911 *6 (S.D.N.Y. May 15, 1992) (dismissing RICO and fraudulent conveyance claims based upon plaintiff's failure to comply with no action clause in indenture); *Friedman v. Chesapeake & Ohio Ry. Co.*, 261 F. Supp. 728, 730-31 and n.1 (S.D.N.Y. 1966) (granting summary judgment to defendants in action by bondholders to recover principal and interest on bonds issued under an indenture based upon plaintiff's failure to comply with no action provision in indenture), *aff'd*, 395 F.2d 663 (2d Cir. 1968), *cert. denied*, 393 U.S. 1016 (1969); *Greene v. New York United Hotels, Inc.*, 260 N.Y.S. 405, 407 (1st Dep't 1932) (complaint based upon non-payment of coupons on debenture bonds secured by a trust mortgage should have been dismissed because plaintiff failed to comply with no action clause contained in trust agreement),[12] *aff'd*, 261 N.Y. 698 (1933); *see also Relmar Holding Co., Inc. v. Paramount Publix Corporation et. al.*, 263 N.Y.S. 776, 778 (Sup. Ct. N.Y. Cty. 1932) (denying motion to strike defense of plaintiff's non-compliance with no action provision in underlying indenture), *aff'd* 237 A.D.2d 870, 261 N.Y.S. 959 (1st Dep't 1993); *cf. Jackson National Life Ins. Co. v. Ladish Co., Inc.*, 92 Civ. 9358 (PKL), 1993 WL 43373 *5-6 (S.D.N.Y. Feb. 18, 1993) (denying summary judgment to plaintiff based upon disputed material facts with respect to whether no action clause prohibited action to accelerate notes).

Plaintiffs concede that they did not comply with § 8.06 of the Indenture. They argue, however, that they are exempt under § 8.07 of the Indenture because this action is based upon the nonpayment of principal and interest on or after the due dates expressed in the security. This argument is based on the theory that the principal of the Wherehouse debentures became due and owing in 1988 when the merger events allegedly triggered the "holder's right to tender." Plaintiffs'

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[12] The *Greene* court held that "[t]he plaintiff as a bondholder holds his securities subject to the condition of this underlying trust agreement and can maintain an action only upon the conditions specified in the trust agreement." *Id.* at 407.

Memorandum in Opposition to Defendants' Motion for Summary Judgment ("Pl. Opp. Memo") at 28-29. I disagree. Even if the events surrounding the merger triggered the "holder's right to tender," the due date "expressed in" the Debenture would remain July 1, 2006. I therefore find that this is not a suit to receive principal due and owing.

Plaintiffs next argue that § 8.06 is unenforceable because the limitations on suit do not appear on the face of the Debentures. Pl. Opp. Memo at 30-32. This argument is based upon *Friedman v. Airlift International, Inc.*, 355 N.Y.S.2d 613 (1st Dep't 1974) and *Cunningham v. Pressed Steel Car Co.*, 265 N.Y.S. 256 (1st Dep't 1933), *aff'd*, 263 N.Y. 671 (1934).

In *Airlift*, the court reversed the dismissal of a debentureholder's suit to recover interest in default, based upon a no action provision in the underlying indenture. The court held that the provision was ineffective because the bond itself did not give adequate notice of the restriction. *Airlift*, 355 N.Y.S.2d at 614-15. The text of the bond, "including the designedly almost illegible small print on the back of the bond," contained two reference pertinent to payment of principal or interest at maturity: 1) that "the interest payable hereon" is "subject to certain exceptions provided in the Indenture"; and 2) a "reference to the indenture for a description of the rights, limitations of rights, obligations, duties and immunities thereunder of the Trustee, the Company and the holders of the Debentures." *Id.* at 614 (internal quotations omitted). The court found that neither of these clauses affected the obligation to pay principal or interest on maturity, and that "[a] reference to another document cannot contradict the promise to pay unless the exception is stated specifically." *Id.* at 614-15. The court emphasized that "[t]he bond itself is intended to be a negotiable instrument. Any limitation on the obligation to pay at maturity appearing on its face would render it non-negotiable. It would appear that defendant has circulated its negotiable promises to pay and now seeks to deny their negotiability. As a matter of law the references in the bond to the indenture do not accomplish this." *Id.* at 615.

In *Cunningham*, the court reversed the denial of summary judgment to plaintiff in a suit for non-payment of principal on

convertible bonds, based upon a no action provision in the underlying trust indenture. The bond itself stated that the it had been "issued under and * * * equally secured by an Indenture dated December 30, 1922, * * * to which Indenture reference is hereby made for a statement of the rights of the holders of said bonds." 265 N.Y.S. at 258 (internal quotations omitted). The court held that the reference to the indenture did not fairly place the bondholder on notice of any restriction upon defendant's obligation to pay at maturity and therefore did not constitute a bar to maintenance of the action for nonpayment. Observing that "the construction defendant now seeks to place upon these bearer bonds would render them nonnegotiable," the court held that "[t]here being no definite restrictive language in the bond which inhibits the bondholder's right to enforcement of the obligation at maturity, any inconsistency between the bond and the indenture must be construed in favor of the bondholder." *Id.* at 260-61. Accordingly, the court granted summary judgment to plaintiff.

In other cases, however, language similar to that appearing on the Wherehouse Debentures has been held to provide sufficient notice of restrictions on suit contained in the underlying debenture. For example, in *Friedman v. Chesapeake*, (cited with approval in *Cruden*) the court held that the following statement on the face of the debenture provided sufficient notice of restrictions in the Indenture to bind the plaintiff:

> in case an event of default, as defined in the Indenture, shall occur, the principal of the Bonds may be declared, or may become, due and payable, in the manner and with the effect provided in the Indenture.

261 F. Supp. at 730. As noted above, the Wherehouse Debentures contain the following provision:

> Securityholders may not enforce the Indenture or the Securities except as provided in the Indenture. The Trustee may require indemnity satisfactory to it before it enforces the Indenture or the Securities.

Debenture § 14. I find that this statement is sufficiently specific to bind the debentureholder to the no action provisions of the Indenture.[13] *See* Defendants' Reply Memorandum in Support of their Motion for Summary Judgment ("Def. Reply Memo") at 21-22.

Plaintiffs next contend that the § 8.06 limitations on suit do not apply to this action because § 8.06 governs only "collective rights," and the holder's right to tender is an individual right. Pl. Opp. Memo at 27-29. I disagree. Section 8.06 makes no distinction between collective and individual rights, and § 8.07, which sets forth the exceptions to § 8.06, provides no exception for a suit for breach of the "holder's right to tender" provision. Moreover, plaintiffs' claim that the merger triggered the "holder's right to tender" would appear to be a "collective right" since it affects all debentureholder in an identical manner. *See* Def. Reply Memo at 17-18.

Plaintiffs next contend that the no action provision applies solely to their contract claims and not to their federal securities claims.[14] Pl. Opp. Memo at 32-33. Plaintiffs rely on *Kusner v. First Pennsylvania Corp.*, 531 F.2d 1234, 1239 (3d

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[13] Defendants also argue that the notice requirements outlined in *Airlift* and *Cunningham* apply solely to actions seeking payment of principal and interest due under the debenture, where such restrictions "impact upon negotiability." Def. Reply Memo at 20-21. In light of my finding that the language on the face of the Wherehouse Debentures was sufficient to bind plaintiffs to the terms of the Indenture, it is unnecessary to address this argument.

[14] Defendants' answer, filed in July 1990 in the *McMahan* case and in August 1990 in the *Thompson* case asserted the no action provision defense with respect to plaintiffs' contract claims, but not with respect to plaintiffs' federal securities claim, because the case upon which defendants now rely to assert this defense with respect to plaintiffs' securities claims (*Victor v. Riklis*) was not decided until May 15, 1992. Defendants' Memorandum in Support of their Motion for Summary Judgment ("Def. Memo") at 45 n.94. Defendants seek leave to amend their answer to assert this affirmative defense as to the federal securities claims. I recommend that this application be granted, and deem the answer amended for purposes of this Report.

Cir. 1976), which held that the following no action clause did not bar plaintiff's § 10(b) action:

> No holder of any Debenture shall have the right to institute any suit, action or proceeding, in equity or at law, for the execution of any trust or power hereof, or for the enforcement of any other remedy under or upon this Indenture, unless * * *.

Id. at 1239 n.6. The *Kusner* court held that "[t]he right which Kusner seeks to vindicate * * * derives not from the Indenture, but from federal law." *Id.* at 1239. The court noted that the defendants had cited "no authority for the proposition that a 'no action' provision in an indenture effectively bars a direct action based upon the federal securities laws. Moreover, the indenture provision * * * does not in terms apply to any action arising other than under the agreement." *Id.; see also Cruden v. Bank of New York*, 85 Civ. 4170 (JFK), 1990 WL 131350 *12 (S.D.N.Y. Sept. 4, 1990) (no action clause does not bar RICO and fraud claims, which did not arise "under the indenture"), *aff'd in part* and *rev'd in part*, 957 F.2d 961 (2d Cir. 1992).

Relying upon *Victor v. Riklis*, 91 Civ. 2897 (LJF), 1992 WL 122911 (S.D.N.Y. May 15, 1992), defendants argue that *Kusner* may be distinguished because the no action provision at issue in that case only barred suits arising under the Indenture itself, whereas the Wherehouse no action provision pertains more broadly to "any remedy with respect to this Indenture *or the Securities*." Indenture § 8.06 (emphasis added). In *Victor*, the court held that the failure to comply with a no action provision required dismissal of both the fraudulent conveyance claims and federal statutory claims arising under RICO. The court reached this holding because, unlike the no action provision in *Kusner*, the no action clause at issue in *Victor* applied to any action seeking "any remedy with respect to [the] Indenture *or the Securities*." *Id.* at *6 (emphasis added) (internal quotations omitted). *Victor* similarly distinguished *Cruden*, 1990 WL 131350 *12 (S.D.N.Y. May 15, 1992), which held that a no action clause did not bar RICO and fraud

claims because they did not arise "under the indenture." *Victor*, at *7 n.7.[15]

I find that § 8.06 is broader than the *Kusner* and *Cruden* no action provisions and applies to all claims asserted in these actions. I also reject plaintiffs' argument that application of the no action provision to federal securities claims "would violate public policy because contract limitations purporting to waive compliance with the securities laws are unenforceable." Pl. Opp. Memo at 33. As defendants point out, the no action provision is analogous to an arbitration clause, which the courts have held to be enforceable. Def. Reply Memo at 23, citing *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 238 (1987).

Finally, plaintiffs argue that they should not be bound by the no action provision because the *McMahan* plaintiffs held over 34 percent of the debentures when their complaint was filed. Pl. Opp. Memo at 29-30. I disagree. Plaintiffs cite no authority for the novel proposition that a party to a contract should be excused from complying with a condition precedent merely because it was *capable* of compliance. Plaintiff essentially asks the court to create a new exception to § 8.06, a request that I find must be rejected.

CONCLUSION

For the reasons set forth above, I find that these actions are barred by plaintiffs' failure to comply with § 8.06 of the Indenture and recommend that defendants' motion for summary judgment dismissing the complaints be granted.

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[15] The *Cruden* no action provision states:

> No holder of any Debenture shall have any right by virtue of or by availing himself of any provision of this Indenture to institute any action or proceedings at law or inequity or in bankruptcy or otherwise, upon or under or with respect to this Indenture, or for the appointment of a receiver or trustee, or for any other remedy hereunder, unless * * *.

Cruden, 1990 WL 13150 *12.

Pursuant to 28 U.S.C. § 636(b)(1)(c) and Rule 72(b) of the Federal Rules of Civil Procedure, the parties shall have ten (10) days from receipt of this Report to file written objections. *See also* Fed. R. Civ. P. 6. Such objections shall be filed with the Clerk of the Court, with extra copies delivered to the chambers of the Honorable Mary Johnson Lowe, Room 803, and to the chambers of the undersigned, Room 631. Any requests for an extension of time for filing objections must be directed to Judge Lowe. Failure to file objections may result in a waiver of those objections for purposes of appeal. *Thomas v. Arn*, 474 U.S. 140 (1985); *Wesolek v. Canadair Ltd.*, 838 F.2d 55, 57-59 (2d Cir. 1988); *McCarthy v. Manson*, 714 F.2d 234, 237-38 (2d Cir. 1983).

DATED: New York, New York
March 11, 1994

Respectfully submitted,

KATHLEEN A. ROBERTS
KATHLEEN A. ROBERTS
UNITED STATES MAGISTRATE JUDGE

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Dkt No: 95-7008
Filed December 15, 1995

At a stated term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, Foley Square, in the City of New York, on the 15th day of December one thousand nine hundred and ninety-five.

MCMAHAN & COMPANY

Plaintiffs-Appellees,

—v.—

WHEREHOUSE

Defendants-Appellants.

A petition for rehearing containing a suggestion that the action be *reheard* in banc having been filed herein by the appellants McMahan & Company, et al.

Upon consideration by the panel that decided the appeal, it is Ordered that said petition for rehearing is DENIED.

It is further noted that the suggestion for rehearing in banc has been transmitted to the judges for the court in regular

active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

FOR THE COURT

GEORGE LANGE III, Clerk

By: BETH J. MEADOR
Beth J. Meador,
Administrative Attorney

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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88 Civ. 0321
88 Civ. 9040

Filed November 4, 1994

MCMAHAN & CO., et al.,

—v.—

WHEREHOUSE ENTERTAINMENT INC. et al.

DON THOMPSON,

—v.—

WHEREHOUSE ENTERTAINMENT INC. et al.

Notice of motion for leave to appeal pursuant to 28 U.S.C. § 1292(b).

Motion by:

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Has consent of opposing counsel:

A. been sought?	☐ Yes	☒ No
B. been obtained?	☐ Yes	☒ No
Has service been effected?	☒ Yes	☐ No
Is oral argument desired?	☐ Yes	☒ No

(Substantive motions only)

Requested return date:

(See Second Circuit Rule 27(b))

Has argument date of appeal been set:

A. by scheduling order?
B. by firm date of argument notice?
C. If Yes, enter date: _____

Judge or agency whose order is being appealed:

Judge Mary Johnson Lowe, U.S. District Court, S.D.N.Y.

Brief statement of the relief requested:

Petition for leave to appeal pursuant to 28 U.S.C. § 1292(b).

By: *(Signature of attorney)*

/s/ DENNIS J. BLOCK
Dennis J. Block

Signed name must be printed beneath

/s/ DENNIS J. BLOCK

Date 11-4-94

Appearing for: *(Name of party)*

WHEREHOUSE ENTERTAINMENT INC. et al.

Appellant or Petitioner:

☐ Plaintiff ☒ Defendant

Appellee or Respondent:

☐ Plaintiff ☐ Defendant

ORDER

Before: WINTER, MAHONEY and JACOBS, C.JJ.

IT IS HEREBY ORDERED that the motion be and it hereby is granted and the cross-petition is denied.

GEORGE LANGE III, Clerk

By: ARTHUR HELLER
Arthur Heller,
Administrative Attorney

1/3/95

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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88 Civ. 9040 (MJL)
88 Civ. 0321 (MJL)

November 30, 1994

MCMAHAN & COMPANY et al. v.
WHEREHOUSE ENTERTAINMENT INC. et al.

ORDER

Before the Court is Defendants' motion requesting the Court to amend its Order of October 21, 1994, certifying for an interlocutory appeal, pursuant to 28 U.S.C. § 1292(b), this Court's Opinion and Order dated August 12, 1994. Defendants request that the Court identify the specific rulings being certified and the reasons why certification under § 1292 is proper.

Plaintiffs oppose the motion to amend on the grounds that Defendants' proposed order incompletely and incorrectly describes the issues to be certified. Plaintiffs also submit a proposed order.

Upon consideration of the parties' proposed orders and the Second Circuit's preference that District Judges certifying orders for appeal state more than their bare finding that the statutory requirements of § 1292(b) have been met, *Isra Fruit Ltd. v. Agrexco Agr. Export Co. Ltd.*, 804 F.2d 24, 25 (2d Cir. 1986), Defendants' motion is granted in the following respects.

This Court believes that two controlling questions of law contained in its August 12, 1994 decision are of such a nature that their immediate resolution by the Court of Appeals might

materially advance the ultimate termination of this litigation. These questions are:

> (1) Whether the "no waiver" provisions of the federal securities laws preclude the assertion of a "no action" clause in an indenture as a defense to Plaintiffs' federal securities claims.
>
> (2) Whether Plaintiffs are entitled to recover damages under Section 11 of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 under a "benefit of the bargain" theory of damages regardless of whether the misrepresentations alleged affected the market value of the Plaintiffs' securities.

Because only the Plaintiffs' federal securities claims remain in this suit, a reversal of this Court's decisions on the aforementioned controlling questions could materially advance the final and full disposition of all of Plaintiffs' claims.

Further, both the substantial grounds for differences of opinion and the absence of clear legal precedent in this Circuit on the two controlling questions are reflected in the opinions of this Court and the Magistrate Judge in this case.

For the foregoing reasons, the Court has certified for immediate appeal pursuant to 28 U.S.C. § 1292(b) its Opinion and Order of August 12, 1994.

It is SO ORDERED.

DATED: New York, New York
November 14, 1994

MARY JOHNSON LOWE
United States District Judge

Copies to:

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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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88 Civ. 9040 (MJL)
88 Civ. 0321 (MJL)

October 13, 1994

MCMAHAN & COMPANY et al. v.
WHEREHOUSE ENTERTAINMENT INC. et al.

ORDER

Before the Court is Defendants' Motion for Certification Pursuant to 28 U.S.C. § 1292(b) of this Court's August 12, 1994 Opinion and Order ("Order").[1]

The Court is of the opinion that the Order involves controlling questions of law as to which there is substantial ground for difference of opinion. The Court also believes that an immediate appeal from the Order may materially advance the ultimate termination of this litigation. Therefore, Defendants' Motion for Certification Pursuant to 28 U.S.C. § 1292(b) is granted. Further proceedings on this action are stayed pending outcome of the interlocutory appeal.

It is SO ORDERED.

DATED: New York, New York
October 13, 1994

MARY JOHNSON LOWE
United States District Judge

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[1] The Defendants move, in the alternative, for reconsideration of the this Court's ruling on the issue of damages. Because the Court finds certification appropriate, it does not address the motion for reconsideration.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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88 Civ. 9040 (MJL)
Filed May 7, 1992

DON THOMPSON,

Plaintiff,

—against—

WHEREHOUSE ENTERTAINMENT, INC., LOUIS A. KWIKER, GEORGE A. SMITH, MICHAEL T. O'KANE, LAWRENCE K. HARRIS, DONALD E. MARTIN, JOEL D. TAUBER, and FURMAN SELZ MAGER DIETZ & BIRNEY, INC.

Defendants.

APPEARANCES:

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BY: JUDITH L. SPANIER, ESQ.

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BY: H. ADAM PRUSSIN, ESQ.
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HOWARD, DARBY & LEVIN[1]
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BY: PHILIP K. HOWARD, ESQ.
LINDA C. GOLDSTEIN, ESQ.

OPINION AND ORDER

MARY JOHNSON LOWE, D.J.

Before this Court is the motion of plaintiff Don Thompson ("Thompson") for an order, pursuant to Fed.R.Civ.P. 23, certifying this case as a class action. This motion was referred to Magistrate Judge Kathleen A. Roberts for a Report and Recommendation, which was issued on February 11, 1992. For the reasons stated below, the Report and Recommendation is affirmed in full and the plaintiff's motion for class certification is granted.

BACKGROUND

The relevant factual background is discussed at length in the Report and Recommendation ("R & R"), familiarity with which will be presumed. We will merely summarize the pertinent details herein.

Pursuant to a prospectus dated July 10, 1986, defendant Wherehouse Entertainment, Inc. ("WEI") issued $50 million of convertible subordinated debentures ("the Debentures") to the public. The Debentures bore interest at a rate of 6-$^1/_4$%

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[1] The law firm of Howard, Darby & Levin represents the plaintiffs in *McMahan & Company, et al. v. Wherehouse Entertainment. Inc., et al.*, 88 Civ. 0321, a companion case to the action currently before us. The two cases have been consolidated for all pretrial purposes.

and were due July 1, 2006. They were generally convertible anytime prior to maturity into shares of WEI common stock unless previously redeemed. The Debentures were sold in increments of $1000 and traded on NASDAQ. Plaintiff Don Thompson bought $71,000 in principal amount of the Debentures between July 21, 1987 and December 21, 1987.

The prospectus contained a number of provisions to protect the debenture holders in the event of a hostile takeover. However, it did not specify the consequences of a friendly takeover. On December 20, 1987, WEI's Board of Directors unanimously approved, with one abstention, a merger agreement with WEI Acquisition Corp. and WEI Holdings, Inc. Because the merger was approved by a majority of WEI's independent directors, the debenture holders' optional right to tender, which arises in the event of a hostile takeover, was not triggered.

Plaintiff filed this action on December 21, 1988, alleging violations of § 11 of the Securities Act of 1933 and § 10(b) of the Securities Exchange Act of 1934. Plaintiff claims these violations were due to the defendant's failure to state in the Prospectus that the optional right to tender would not be triggered in the event of a friendly acquisition. Plaintiff has also asserted pendent state law claims.

The companion case to this action, *McMahan v. Wherehouse Entertainment, Inc.*, 88 Civ. 0321 ("McMahan Action"), was filed on January 15, 1988. Plaintiffs in the McMahan Action are financial institutions which purchased 34% of the Debentures. On February 23, 1988, defendants in the McMahan Action moved to dismiss the complaint and for a protective order staying discovery pending resolution of the motion. During the pendency of the motion in the McMahan Action, this action (the "Thompson Action") was stayed. In addition, during the pendency of an appeal of this Court's Opinion which granted the motion to dismiss in the McMahan Action, the Thompson Action was placed on the Court's suspense docket. On April 10, 1990, the United States Court of Appeals for the Second Circuit remanded the McMahan

Action to this Court. *See* 900 F.2d 576 (2d Cir. 1990). The Thompson Action was subsequently removed from the suspense docket and plaintiff moved for class certification on July 2, 1990. The motion for class certification was referred to Magistrate Judge Roberts for a Report and Recommendation, which was issued on February 11, 1992.

DISCUSSION

Pursuant to 28 U.S.C. § 636(b)(1)(B) and Fed.R.Civ.P. 72(b), a decision by a magistrate judge on a dispositive matter shall be reviewed *de novo* by the District Court if any objections to the decision are submitted. However, if no objections are filed, the District Court need only satisfy itself that there is no clear error on the face of the record in order to accept the recommendation. *Campbell v. United States Dist. Court*, 501 F.2d 196, 206 (9th Cir. 1974), *cert. denied* 419 U.S. 879; *see also* Fed.R.Civ.P. 72. Defendant's have submitted objections only to that portion of the R & R which found, pursuant to Fed.R.Civ.P. 23(b)(3), that "a class action is superior to other available methods for the fair and efficient adjudication of the controversy." *Id.* Thus, we will initially discuss the other elements of the R & R, according to the 'clear error' standard, and then move on to a *de novo* determination of the question of superiority of a class action as the method for resolving this and related actions.

Based on our review of the R & R, we find that the magistrate judge's findings regarding the elements of Rule 23(a) are wellgrounded in both the facts of the matter before us and the law by which we are bound in evaluating those facts. According to Rule 23(a), in order to establish a class for certification, plaintiff must establish the following:

> (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or

> defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

Fed.R.Civ.P. 23(a). The only dispute concerning Rule 23(a) before the magistrate judge was with regard to the requirements of Rule 23(a)(3). This element of the rule requires that the "claims or defenses of the representative parties are typical of the claims or defenses of the class." Defendants claimed before the magistrate judge that:

> plaintiff's claims are not based on the same legal theory as that of other proposed class members because plaintiff cannot assert claims based upon the oral "roadshow" misrepresentations, such as those asserted in *McMahan* under § 12(2) of the Securities Act. . . . Defendants claim that Thompson does not have standing to assert a claim under § 12(2) based on alleged oral misrepresentations because he bought his Debentures on the secondary market and claims not to have relied on oral representations.

R & R, February 11, 1992, at 9. Thus, argued defendants, plaintiff's claims are not "typical" as required by Rule 23.

On this point, Magistrate Judge Roberts found that plaintiff's claims are, in fact, typical to all members of the proposed class because they "are based primarily on a single document, the Prospectus, which was concededly provided to all members of the proposed class." *Id.* at 10. Thus, it is clear that there is a factual nucleus that is common to all proposed class members and provides the required "typicality" element of Rule 23. We, therefore, find no error in the magistrate judge's determination of this issue and adopt this portion of her recommendation in full.

In addition to fulfilling the requirements of Rule 23(a), plaintiff must further establish one element listed in Rule 23(b), which delineates the circumstances under which a class action may be maintained. Plaintiff argues that Fed.R.Civ.P. 23(b)(3) is applicable here. Pursuant to Rule 23(b)(3), in

order for a class to be maintained, the court must find that there are common questions of law or fact which predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fair and efficient adjudication of the controversy. The defendants argued before the magistrate judge that plaintiff had failed to show both of the required elements of Rule 23(b)(3).

With regard to the issue of common questions of law or fact, the magistrate judge found that,

> the common factual and legal questions in this suit predominate over any individual questions, since liability will depend upon a determination of whether defendants' conduct in preparing and disseminating the Prospectus, which was received by every person who purchased Debentures, violated § 11 of the Securities Act of 1933 and § 10(b) of the Securities Exchange Act of 1934.

Report and Recommendation at 17. The defendants have not objected to this finding in their submissions to this Court. In evaluating the conclusions of the magistrate judge in light of the 'clear error' standard, we fully agree with her determination regarding the core inquiry in this action. The alleged acts which form the basis of the claims of plaintiff and other prospective class members are essentially the same. In addition, the questions of law that must be determined in the actions will involve analyses of identical legal guidelines, those arising under the Securities Act of 1933 and the Securities Exchange Act of 1934. Thus, we adopt the magistrate judge's recommendation on this element, as well.

The final determination made by the magistrate judge was that a class action would be the superior method of adjudication of this action. On this point, defendants have objected to the magistrate judge's recommendation. Specifically, defendants argue that

> [the] debentureholders have a strong interest in controlling their own individual actions, and have enough at stake to make individual actions economically feasible.

> Consequently, plaintiff has not established, as required by Rule 23(b)(3), that a class action would be the superior method for resolving these claims.

Defendants' Objections to Report and Recommendation, March 9, 1992 ("Defendants Objections"), at 2. In her discussion of this point, the magistrate judge aptly articulated that "private causes of actions for violations of the securities laws constitute an essential tool for enforcement of these laws." *Id.* at 14 (*citing Basic Inc. v. Levinson*, 485 U.S. 224, 230-231 (1988)). Furthermore, "the essential purpose of Rule 23 is 'to encourage suits to redress rights where claims would otherwise be too small to warrant individual litigation.' " *Id.* (*quoting Free World Foreign Car, Inc. v. Alfa Romeo*, 55 F.R.D. 26, 30 (S.D.N.Y. 1972)). Pursuant to these guiding principals, the magistrate judge found, *inter alia*, as follows.

> Since the claims asserted all stem from the alleged misrepresentations and omissions in the Prospectus, it would be in the interest of judicial economy to make factual findings as to a class, and not to have a number of suits seeking adjudications of the same factual issue. Further, to deny class certification in the case at bar would likely sound the "death knell" of the class claims, since class members who did not intervene in plaintiff's case within a matter of hours would be barred by the statute of limitations in commencing individual § 11 suits. Efficiency, uniformity of decision, expense, and the likelihood that many claims will not be pursued without the class action all favor class certification.

Id. at 16.

Based on our *de novo* review of the record before us, we find that Magistrate Judge Roberts' recommendations on this point are fully in line with the applicable law. Pursuant to Rule 23(b)(3), the relevant issues to be considered in determining the issue of superiority are:

> (A) the interest of members of the class in individually controlling the prosecution or defense of separate

> actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action.

Fed.R.Civ.P. 23(b)(3). As quoted above, defendants arguments against class certification consist of their claims that many prospective class members have sufficiently large stakes that they could proceed individually. In addition, plaintiff argues that any inefficiencies or economic hardships that would result in such individual actions can be overcome by co-operation with the plaintiffs and counsel in this and the McMahan actions and consolidation with these existing actions. *See* Defendants' Objections at 15, 22.

Defendants oppose the use of a class action for fear of a "multimillion claim under the guise of protecting the rights of others who have no need of this plaintiff's protection." Defendants' Objections at 17-18. They clearly fear less from what they suggest as an alternative: the consolidated litigation of multiple actions, which are so similar that joint litigation is appropriate. *See*, e.g., Defendants' Objections at 15, 16, 22. Given the conceded factual and legal similarities among this action and those of potential class members, presented in sharp relief by defendants' own arguments on these points, we are lead to the conclusion that class certification is, indeed, wholly appropriate to efficiently and economically join these claims in a coordinated and manageable litigation. While it is important to acknowledge the possible dangers of an abusive use of the class action procedure, we do not find such abuse indicated here. *See Epifano v. Boardroom Business Products, Inc.*, 130 F.R.D. 295, 299 (S.D.N.Y. 1990); *Stoudt v. E.F. Hutton & Co., Inc.*, 121 F.R.D. 36 (S.D.N.Y. 1988). Efficiency and economy, for the Court and the litigants, will clearly be best served by avoiding the multiplicity of actions that consolidation, as opposed to class certification, would create. Further, class certification will avoid the possibility of incon-

sistent factual determinations, a possibility that would be greatly increased by separate trials of each action.

Defendants also argue that the "vast majority" of debentureholders owned large enough amounts to give them financial incentive to litigate individually and, thus, a class action is not a superior method by which to litigate these actions. However, the fact that no debentureholders other than Thompson and those in the McMahan Action had filed, by the eve of the expiration of the statute of limitation, indicates that these prospective class members do not have sufficient ability or incentive to litigate individually.[2] Rather, it seems likely that the costs of complicated federal securities litigation, even in the face of a $60,000 or more claim, is a daunting task to take on for any plaintiff. *See Epifano v. Boardroom Business Products, Inc.*, 130 F.R.D. 295, 299 (S.D.N.Y. 1990) (Although the damages claimed ranged from $50,000 to $285,000, given the complexity of securities law cases and the high cost of litigation, it was not clear that the cases would have been pursued without the class action possibility); *McMahon Books, Inc. v. Willow Grove Associates*, 108 F.R.D. 32 (E.D. Pa. 1985). Further, there are significant debentureholders who are not the large stakeholders described by defendants and who may be financially incapable of individually pursuing such a litigation. *See* Plaintiff's Reply to Defendants' Objections to Report and Recommendation, March 30, 1992, at 15.

In addition to the costs of litigation, the time in which other potential plaintiffs could file suit if this motion were denied is prohibitively short. When this motion was filed there was one day left in which any other debentureholders could have filed claims pursuant to § 11 of the Securities Act before the expiration of the statute of limitations. Thus, if certification

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[2] Such failure to file suit cannot, as defendants suggest, be taken as an indication of the weakness of plaintiff's claims. *Sirota v. Solitron Devices, Inc.*, 673 F.2d 566, 572 (2d Cir. 1982), *cert. denied*, 459 U.S. 838 (1982) (It would be improper for a district court to resolve substantial questions of fact going to the merits when deciding the scope or time limits of the class).

were to be denied here, there would be a window of only one day in which such claims could be filed. Fairness clearly dictates that we may take into account the expiration of the § 11 claims of the prospective class members in making our determination here. While this consideration alone may not mandate class certification, when it is evaluated in light of the other circumstances of this action, we find it additionally persuasive.

Thus, in our evaluation of these issues, we find that the guidelines of Rule 23 clearly contemplate class certification in exactly the circumstances that are before us. *See Korn v. Franchard Corp.*, 456 F.2d 1206 (2d Cir. 1972); *Epifano v. Boardroom Business Products, Inc.*, 130 F.R.D. 295 (S.D.N.Y. 1990)(In spite of large damage claims, given the complexity of securities law cases, and the high cost of litigation, it is not clear that the cases would have been pursued without the class certification possibility.); *Tedesco v. Mishkin*, 689 F.Supp. 1327 (S.D.N.Y. 1988); *Esplin v. Hirschi*, 402 F.2d 94, 101 (10th Cir. 1968), *cert. denied*, 394 U.S. 928 (Federal remedies in the context of securities laws may depend on the applicability of the class action device). For these reasons, we find that class action is a superior method by which to adjudicate this controversy and, therefore, affirm the Report and Recommendation on this point as well.

CONCLUSION

For the reasons stated above, we adopt the Report and Recommendation of Magistrate Judge Kathleen A. Roberts, dated February 11, 1992, in full. Plaintiff's motion for class certification is granted. This action, as well as the companion McMahan Action, shall remain with Magistrate Judge Roberts for pretrial supervision.

It Is So Ordered.

Dated: New York, New York
April 24, 1992

/s/ MARY JOHNSON LOWE
United States District Judge

ORDER OF THE UNITED STATES SUPREME COURT

June 28, 1991

Certiorari Denied

No. 90-293. WHEREHOUSE ENTERTAINMENT, INC., ET. AL. *v.* MCMAHAN & CO. ET. AL. C.A. 2d Cir. Certiorari denied. Reported below: 900 F.2d 576.

Opinion of the United States Court of Appeals
For the Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 399—August Term 1989

Argued: December 19, 1989 Decided: April 10, 1990

Docket No. 89-7664

MCMAHAN & COMPANY, FROLEY, REVY INVESTMENT CO., INC. and WECHSLER & KRUMHOLZ, INC.,

Plaintiffs-Appellants,

—against—

WHEREHOUSE ENTERTAINMENT, INC., LOUIS A. KWIKER, GEORGE A. SMITH, MICHAEL T. O'KANE, LAWRENCE K. HARRIS, DONALD E. MARTIN, JOEL D. TAUBER, FURMAN SELZ MAGER DIETZ & BIRNEY, INC., WEI ACQUISITION CORP., WEI HOLDINGS, INC., ADLER & SHAYKIN, and CHEMICAL BANK,

Defendants-Appellees.

Before:

OAKES, PRATT, *Circuit Judges*, and
LEONARD B. SAND, United States District Judge
for the Southern District of New York,
sitting by designation.

Plaintiffs appeal from summary judgment of United States District Court for Southern District of New York, Mary Johnson Lowe, *Judge*, dismissing complaint charging securities violations based on misrepresentation in debenture offering.

Reversed and remanded. Judge Sand dissents in a separate opinion.

PHILIP K. HOWARD, New York, NY (Howard, Darby & Levin, Warren G. Caywood, Jr., Bonnie Blacklock, of Counsel), *for Appellant McMahan*.

DENNIS J. BLOCK, New York, NY (Weil, Gotshal & Manges, H. Adam Prussin, Richard B. Friedman, Miranda S. Schiller, of Counsel), *for Appellee Wherehouse*.

PRATT, *Circuit Judge*:

Plaintiffs appeal from a judgment of the United States District Court for the Southern District of New York, Mary Johnson Lowe, *Judge*, dismissing their complaint that defendants made material misrepresentations and omissions in a debenture offering in violation of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j; § 11 of the Securities Act of 1933, 15 U.S.C. § 77k; and § 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l*. Finding that the complaint "fail[ed] to

allege any omission or misstatement of fact—material or otherwise—within the meaning of the securities laws", the district court granted summary judgment to defendants. The court also dismissed plaintiffs' state-law claims for lack of pendent jurisdiction. Since we conclude that plaintiffs presented sufficient evidence to create a genuine issue as to whether the offering was materially misleading, we reverse the summary judgment and remand the case for further proceedings.

BACKGROUND

Defendant Wherehouse Entertainment, Inc. offered 6-1/4% convertible subordinated debentures whose key selling feature was a right of holders to tender the debentures to Wherehouse in the case of certain triggering events which might endanger the value of the debentures. The tender right was to arise if:

> (a) A person or group * * * shall attain the beneficial ownership * * * of an equity interest representing at least 80% of the voting power * * * unless such attainment has been approved by a majority of the Independent Directors;
>
> (b) The Company * * * consolidates or merges * * * unless approved by a majority of the Independent Directors;
>
> (c) The Company * * * incurs * * * any Debt * * * excluding * * * Debt which is authorized or ratified by a majority of the Independent Directors, immediately after the incurrence of which the ratio of the Company's Consolidated Total Debt to its Consolidated Capitalization exceeds .65 to 1.0.

Indenture § 5.02, 11-12 (June 15, 1986); *see also* Prospectus *Summary*, "Optional Tender", 3 (July 10, 1986); *id. Description of Debentures*, "Optional Debenture Tender", 25-26.

The offering materials defined an "Independent Director" as "a director of the Company" who was not a recent employee but who was a member of the board of directors on the date of the offering or who was subsequently elected to the board by the then-Independent Directors. Indenture, § 5.02, 12; Prospectus *Description of Debentures*, "Optional Debenture Tender", 26. The reason offered for this unusual right to tender was that it would be a protection against certain forms of takeover attempts, including leveraged buy-outs. Prospectus *Description of Debentures*, "Effect on Certain Takeovers", 27. At the heart of this appeal is the meaning of the limitation placed on the right to tender by the role of "Independent Directors".

Plaintiffs are financial institutions that purchased 34% of the convertible debentures. Eighteen months after the purchase, Wherehouse entered into a merger agreement with defendants WEI Holdings, Inc. and its subsidiary WEI Acquisition Corp. The practical effect of the merger, accomplished through a leveraged buy-out, left Wherehouse with a debt approaching 90% of its capitalization and left plaintiffs' debentures valued at only approximately 50% of par. Plaintiffs attempted to exercise their right to tender, but the company refused to redeem the debentures on the ground that the "board of directors" had approved the merger. Plaintiffs then commenced this suit for damages and an injunction to prevent the merger. Named as defendants were Wherehouse, various officers of Wherehouse, the underwriter

of the debentures, WEI Holdings, Inc., WEI Acquisition Corp., and the bank that was financing the tender offer. Plaintiffs claimed that the descriptions of the debentures in the registration materials, as well as representations made during conversations, were materially misleading. Specifically, they claimed that, even though the defendants knew that the right to tender was illusory, their representations of the right as valuable and protected had misled investors into buying the debentures and therefore violated federal securities laws. In the alternative, claiming that the representations created a right to tender under the contract, plaintiffs asserted state-law claims of breach of contract, interference with contract, breach of implied duty of good faith, and fraudulent conveyance.

Defendants argued that all the relevant provisions were clear and unambiguous and that no false statements were made; thus the offering was not materially misleading or in violation of the securities laws.

The district court found nothing misleading. It granted summary judgment to defendants and dismissed plaintiffs' state-law claims for lack of pendent jurisdiction. The district court held that defendants were not required to speculate about the likelihood of a waiver of debentureholders' rights by the Independent Directors and that, even if the right were worthless, defendants were not required to use pejorative terms describing it as such. Moreover, it found the tender option was not illusory, because it (was possible that it) might provide a benefit to debentureholders in the case of a takeover hostile to shareholders which management chose to fight. Finally, according to the district court, the definition of "Independent Directors" was adequate because

further description of their role, the extent of their discretion, their interests, or their intent would constitute mere legal conclusions, characterizations, or descriptions of underlying motives and were not required disclosures. Thus, the district court found that the descriptions of the right were not misstatements, and that the alleged omissions were not required to be disclosed under the securities laws.

We disagree with the district court's atomistic consideration of the presentation of the debentureholders' right to tender. The district court concluded that defendants had not misled plaintiffs because the information they included in the written and oral representations was "literally true". We think, however, that when read as a whole, the defendants' representations connoted a richer message than that conveyed by a literal reading of the statements. The central issue on all three claims is not whether the particular statements, taken separately, were literally true, but whether defendants' representations, taken together and in context, would have mislead a reasonable investor about the nature of the debentures.

Some statements, although literally accurate, can become, through their context and manner of presentation, devices which mislead investors. For that reason, the disclosure required by the securities laws is measured not by literal truth, but by the ability of the material to accurately inform rather than mislead prospective buyers. *Greenapple v. Detroit Edison Co.*, 618 F.2d 198, 205 (2d Cir. 1980) (where method of presentation or "gloss" placed on information obscures or distorts significance of material facts, it is misleading). Even " 'a statement which is literally true, if susceptible to quite another interpretation by the reasonable investor * * *

may properly * * * be considered a material misrepresentation.' " *Beecher v. Able*, 374 F. Supp. 341, 347 (S.D.N.Y. 1974) *quoting SEC v. First American Bank & Trust Co.*, 481 F.2d 673 (8th Cir. 1973).

We hold that the district court erred in granting summary judgment to the defendants; because plaintiffs have raised a triable issue as to whether the written and oral representations about the right to tender these debentures were materially misleading to a reasonable investor in violation of § 11 and § 12 of the 1933 Securities Act and also of § 10(b) of the 1934 Securities Exchange Act. Since the analysis for all three securities claims is similar, we will first consider it in some detail under § 11, and then review it only briefly under §§ 12 and 10(b).

A. *Section 11 of the Securities Act of 1933*

Section 11 states that any signer, officer of the issuer, and underwriter may be held liable for a registration statement which "contained an untrue statement of a material fact or omitted to state a material fact * * * necessary to make the statements therein not misleading". Plaintiffs claim that these offering materials misstated the right to tender and omitted important information about it in violation of § 11. They argue that a reasonable investor would have believed that the right to tender was valuable because it was presented as a right to be exercised at the holder's option and as a protection against takeovers that might affect the security of the debentures. In truth, however, the right to tender was illusory, they argue, because it was designed to be exercised only at the option of management and

therefore was intended to protect the interests of shareholders, not of debentureholders.

Plaintiffs are correct that the offering materials can reasonably be read to present the option to tender as a valuable right. The language used was invariably language of entitlement:

> *Holder's Right to Tender.* The Holder of any Security or Securities shall have *the right, at his option,* * * * *to tender* for redemption any such Security or Securities.

Indenture § 5.01, 10 (emphasis added). The prospectus summary provided that:

> "Each holder of Debentures has the *option to require* the Company to redeem the holder's Debentures."

"Optional Tender", 3 (emphasis added). And the prospectus itself stated:

> "Holders of the Debentures *will have the option* * * * *to require* the Company to redeem such Debentures."

Description of Debentures, "Optional Debenture Tender", 25 (emphasis added).

Further, a jury could reasonably view the presentation of the right to tender as a special feature to protect investors, for the offering materials stressed the purported value of the right in any takeover transaction which would threaten the value of the debentures.

> Since the events which give rise to such right of redemption could be expected to occur in connection with certain forms of takeover attempts, the

> optional tender provisions could deter takeovers where the person attempting the takeover views itself as unable to finance the redemption of the principal amount of Debentures which may be tendered * * * To the extent that Debentures may be tendered * * * the Company would be unable to use the financing provided by the sale of the Debentures offered hereby. In addition, the ability of the Company to obtain additional Senior Debt based on the existence of the Debentures would be similarly adversely affected.

Prospectus *Description of Debentures*, "Effect on Certain Takeovers", 27; *see also id.* "Optional Debenture Tender", 26.

Finally, the right was restricted only in that it was subject to action by "the Independent Directors". Similar language describing the restriction—the right to tender occurs upon a triggering event, "*unless* [the event is] approved by a majority of the Independent Directors" (emphasis added)—is found in the Indenture, § 5.02, 11-12; in the prospectus summary, "Optional Tender", 3; and again in the full prospectus, *Description of Debentures*, "Optional Debenture Tender", 25-26. A jury could reasonably find that this repeated use of the word "unless" encouraged the inference that exercise of the right would be the norm and that waiver would be the exception.

Although the offering materials explain that the Independent Directors would be chosen from the company's board of directors, the term "Independent Director" implies a special status, some distinction from an "ordinary" director. The term suggests that these directors would be "independent" of management and the nor-

mal obligations of board members to act in the interests of shareholders. Thus the restriction could reasonably be understood to mean that in the case of a triggering event, the right to tender would arise *unless* the Independent Directors find the event to be in the interests of the debentureholders. In short, as plaintiffs argue, a reasonable investor could have regarded the right to tender as a valuable right, protected by Independent Directors who would, in situations endangering the security of the debentures, consider debentureholders' interests before approving any waiver of their right.

By thus representing that in a takeover context the Independent Directors would be considering the interests of debentureholders, the defendants implied that the Independent Directors had a duty to protect the debentureholders' interests. Defendants, however, have shown nothing in their corporate charter or by-laws that would have permitted, much less required, these Independent Directors to favor debentureholders over shareholders. Moreover, at the time of the approval of this merger, the Independent Directors constituted all but one of the "ordinary" directors on the board. As ordinary directors, they had a fiduciary duty to protect the interests of shareholders in any takeover situation, regardless of debentureholders' interests or rights. It is inevitable, then, that the so-called Independent Directors had no independence; they would never protect the interests of debentureholders except by coincidence because, as ordinary directors, they were required by law to protect the interests of the shareholders. From this perspective, there is merit in plaintiffs' contentions that the right to tender was illusory and that the representations of it in the offering materials were misleading.

In sum, on a fair reading of the offering materials, despite their literal meaning, an investor could have reasonably believed that the tender option was presented as a valuable right for debentureholders; that it provided a special feature of protection for their interests; and that Independent Directors were to render independent votes on the right to tender based on the impact of a merger and on the interests of debentureholders. But if, as plaintiffs claim, the right to tender was illusory because the Independent Directors were tied to management, served its needs, protected shareholders' interests, and would inevitably waive the right in any merger beneficial to management regardless of debentureholders' interests, then the offering materials could be found by a rational trier of fact to be materially misleading in violation of § 11 of the Securities Act of 1933. Plaintiffs have therefore raised a genuine issue as to whether the written representations could have misled a reasonable investor, *Greenapple*, 618 F.2d at 205, and summary judgment was therefore unwarranted.

B. *Section 12 of the Securities Act of 1933*

Section 12(2) of the Securities Act of 1933 presents a problem similar to § 11, but it has the added factor of oral representations made to the investors in order to induce them to purchase. Section 12(2) states that anyone who makes a securities offering "by means of a prospectus *or oral communication*, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements * * * not misleading * * * shall be liable" (emphasis added). In an affidavit, Thomas Revy of plaintiff Froley, Revy, alleges that in a phone conversation and at a "due diligence" lunch, officers of Wherehouse specifi-

cally represented that the debentures included the right to tender as a "protective covenant for the debentureholders" against takeovers. Plaintiffs claim these oral communications were untrue and violated § 12(2).

Defendants argue that the statements were accurate because they would protect holders in the event of a takeover that was hostile to management. The district court agreed, finding that "where the company might find itself subjected to an hostile takeover, the right to tender could, indeed, be 'protective' of the debentureholders' interests."

However, the language used—"protective covenant" and "special protection"—is promissory and unrestricted. The statements clearly imply that the protection to debentureholders would extend to the case of any takeover hostile to the holders' rights. It would be, to say the least, a cramped interpretation to view the right to tender as a "protective covenant for the debentureholders" if its protection were limited to a takeover that was hostile only to management and the shareholders. Finally, by representing that this special right to tender was the key selling feature of other wise low-value debentures, defendants could be found to have implied that debentureholders would be protected against takeovers hostile to their own interests, regardless of the interests of shareholders, and thus to have misled plaintiffs as to the true nature of the right. Summary judgment was therefore inappropriate on plaintiffs' § 12(2) claim.

C. *Section 10(b) of the Securities Exchange Act of 1934*

Section 10(b) of the Securities Exchange Act of 1934, the general fraud provision of the act, prohibits any per-

son from using or employing "any manipulative or deceptive device" in connection with the sale of a security. To state a claim under this section, plaintiffs "must allege material misstatements or omissions indicating an intent to deceive or defraud in connection with the purchase or sale of a security." *Luce v. Edelstein*, 802 F.2d 49, 55 (2d Cir. 1986); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). Plaintiffs claim that disclosure of the true nature of the tender provision not only would have altered a reasonable investor's investment decision, but would have dissuaded investment here by showing these debentures to be a poor risk. They allege that Wherehouse knew this and so deliberately misrepresented the right-to-tender feature, thereby misleading investors in violation of § 10(b).

The district court, having dismissed the claims under § 11, found it was therefore impossible to state a § 10(b) claim. Since we have concluded that a question of fact is presented as to whether the offering materials and the oral communications, taken together, could have misled a reasonable investor, it follows that a jury should also determine whether the defendants violated of § 10(b).

D. *Pendent Claims*

Since the only reason for the district court's dismissing plaintiff's pendent state-law claims was that the federal basis for jurisdiction had disappeared, now that we have reinstated the federal claims, the pendent claims are reinstated as well.

Reversed and remanded.

SAND, *District Judge*:

The reasons why I am constrained to dissent may be briefly stated.

The question whether an anti-takeover provision provides a "special protection" to debentureholders cannot be answered in the negative merely because the "Independent Directors" decided to waive its provisions and approve a particular transaction. These directors were explicitly empowered to act in this fashion by virtue of the fully disclosed terms of the provision. A significant function of an anti-takeover provision is to serve as a deterrent to hostile takeovers, including takeovers which would be contrary to the interests of both shareholders and debenture-holders. One cannot, I believe, fairly characterize such a provision as being "worthless" to the debentureholders, even though as a matter of Delaware law directors owe a fiduciary duty solely to shareholders. The anti-takeover provision was therefore a "special protection" to debentureholders, albeit a limited one.

Federal securities laws do not impose an obligation to advise investors of the fundamentals of corporate governance. The disclosure required by the federal securities laws is not a "rite of confession or exercise in common law pleading. What is required is the disclosure of material objective factual matters." *Data Probe Acquisition Corp. v. Data Lab, Inc.*, 722 F.2d 1, 5-6 (2d Cir. 1983), *cert. denied*, 415 U.S. 1052 (1984). Especially is this so where, as here, the investor-complainants are sophisticated financial institutions making major investments. The role of the federal securities laws is not to remedy all perceived injustices in securities transactions. Rather,

as invoked in this case, it proscribes only the making of false and misleading statements or material omissions.

Whether the Independent Directors breached an implied duty of good faith or otherwise acted contrary to their fiduciary obligations are matters of state law. Here, the federal claims were asserted only conditionally, the express condition being the failure of the state law claims. These state claims were properly dismissed by the court below for lack of pendent jurisdiction.

Believing no valid federal claim to be present, I would affirm essentially for the reasons set forth in the Opinions of the Magistrate and District Court.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Docket No. 89-7664

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the tenth day of April, one thousand nine hundred and ninety.

Present: HON. JAMES L. OAKES, Ch.J.
HON. GEORGE C. PRATT, C.J.
HON. LEONARD B. SAND, D.J.*

Circuit Judges,

MCMAHAN & COMPANY, FROLEY, REVY INVESTMENT CO., INC., and WECHSLER & KRUMHOLZ, INC.,

Plaintiffs-Appellants,

—against—

WHEREHOUSE ENTERTAINMENT, INC., LOUIS A. KWIKER, GEORGE A. SMITH, MICHAEL T. O'KANE, LAWRENCE K. HARRIS, DONALD E. MARTIN, JOEL D. TAUBER, FURMAN SELZ MAGER DIETZ & BIRNEY, INC., WEI ACQUISITION CORP., WEI HOLDINGS, INC., ADLER & SHAYKIN, and CHEMICAL BANK,

Defendants-Appellees.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK.

* Hon. Leonard B. Sand, U.S. District Judge, for the Southern District of New York, sitting by designation.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the Judgment of said District Court be and it hereby is reversed and the action be and it hereby is remanded to the said District Court for further proceedings in accordance with the opinion of this Court with costs to be taxed against the appellees.

ELAINE B. GOLDSMITH
Clerk

By: /s/ EDWARD J. GUARDARO
EDWARD J. GUARDARO
Deputy Clerk

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Docket No. 89-7664

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the 16th day of May one thousand nine hundred and ninety.

Present: Hon. James L. Oakes, Chief Judge,
Hon. George C. Pratt, Circuit Judges.
Hon Leonard B. Sand, District Judge.

Circuit Judges,

MCMAHAN & COMPANY, FROLEY, REVY INVESTMENT CO., INC. and WECHSLER & KRUMHOLZ, INC.,

Plaintiffs-Appellants,

—v.—

WHEREHOUSE ENTERTAINMENT, INC., LOUIS A. KWIKER, GEORGE A. SMITH, MICHAEL T. O'KANE, LAWRENCE K. HARRIS, DONALD E. MARTIN, JOEL D. TAUBER, FURMAN SELZ MAGER DIETZ & BIRNEY INC., WEI ACQUISITION CORP., WEI HOLDINGS, INC., ADLER & SHAYKIN, and CHEMICAL BANK,

Defendants-Appellees.

A petition for a rehearing having been filed herein by Appellees WHEREHOUSE ENTERTAINMENT, INC. ET AL.

Upon consideration thereof, it is Ordered that said petition be and it hereby is DENIED.

Elaine B. Goldsmith,
Clerk

Opinion and Order

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

88 Civ. 0321 (MJL)

MCMAHAN & COMPANY, FROLEY, REVY INVESTMENT CO., INC., and WECHSLER & KRUMHOLZ, INC.,

Plaintiffs,

—against—

WHEREHOUSE ENTERTAINMENT, INC., LOUIS A. KWIKER, GEORGE A. SMITH, MICHAEL T. O'KANE, LAWRENCE K. HARRIS, DONALD E. MARTIN, JOEL D. TAUBER, FURMAN SELZ MAGER DIETZ & BIRNEY INCORPORATED, WEI ACQUISITION CORP., WEI HOLDINGS, INC., ADLER & SHAYKIN, and CHEMICAL BANK,

Defendants.

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MARY JOHNSON LOWE, D.J.

Before this Court are defendants' motions to dismiss the plaintiffs' Revised Amended Complaint ("Complaint") pursuant to Fed.R.Civ.P. 12(b)(1), for lack of subject matter jurisdiction, and 12(b)(6), for failure to state a claim upon which relief can be granted. The motions were referred to Magistrate Roberts on March 21, 1988 for a Report and Recommendation ("R & R"). On notice to the parties, the Magistrate thereafter converted the asserted claims into a motion for summary judgment pursuant to Fed.R.Civ.P. 56. For the reasons set forth below, we adopt the reasoning of the Magistrate's R & R and dismiss Counts Three, Four and Five of plaintiffs' Complaint, which allege various violations of the federal securities laws, pursuant to Fed.R.Civ.P. 56. The remaining state law claims are dismissed for lack of subject matter jurisdiction pursuant to Fed.R.Civ.P. 12(b)(1).

BACKGROUND

This action revolves around a merger agreement between defendant Wherehouse Entertainment, Inc. ("Wherehouse") and defendants WEI Holdings, Incorporated ("Holdings") and its subsidiary WEI Acquisition Corporation ("Acquisition"). Wherehouse is a Delaware corporation which owns and operates record stores in the western United States. Complaint at ¶ 9. Acquisition and Holdings are both Delaware corporations with their principal places of business in New York City. Holdings is owned by defendant Adler & Shaykin ("A & D"), a partnership also located in New York City. *Id.*

at ¶ 17. Also named as defendants are Louis A. Kwiker ("Kwiker"), Wherehouse's Chief Executive Officer, President and director; George A. Smith, Michael T. O'Kane, Lawrence K. Harris, Donald E. Martin, and Joel D. Tauber (collectively the "Independent Directors"), all of whom are directors of defendant Wherehouse, *Id.* at ¶¶ 10-16; Furman Selz Mager Dietz & Birney, Incorporated ("Furman Selz"), a corporation which purportedly acted as advisor to Wherehouse in negotiating the merger and underwrote the debentures at issue in this action *Id.* at ¶ 50; and Chemical Bank ("Chemical"), a New York banking corporation which agreed to provide the financing for the tender offer which led to Acquisition's eventual merger into Wherehouse. *Id.* at ¶ 19.

The plaintiffs McMahan & Company ("McMahan"), Froley, Revy Investment Company, Incorporated ("Froley Revy"), and Wechsler & Krumholz, Incorporated ("W & K") are financial institutions which hold thirty-four percent of Wherehouse's convertible debentures. As debentureholders, and pursuant to the terms of the governing Indenture, plaintiffs were provided with a "right to tender" the debentures to Wherehouse at their principal amount, along with a specified amount in the early years. As the plain language of the Indenture makes clear, however, this right to tender was not absolute. Rather, the right was conditioned upon the occurrence of certain "triggering" events, namely when:

> (a) A person or group . . . shall attain the beneficial ownership . . . of an equity interest representing at least 80% of the voting power for election of the Board of Directors of the Company *unless such attainment has been approved by a majority of the Independent Directors*; [or]
>
> (b) The Company . . . consolidates or merges with any other person . . . *unless approved by a majority of the Independent Directors*; [or]
>
> (c) The Company or any Subsidiary incurs, issues, assumes, guarantees or creates any Debt, or pledges any Company or Subsidiary assets to secure repay-

> ment of any Debt, *excluding* Debt existing on July 9, 1986 and *Debt which is authorized or ratified by a majority of the Independent Directors.*

Indenture between Wherehouse and Bank of America National Trust and Savings Association ("Indenture"), § 5.02 (emphasis supplied). As the language of this provision also makes clear, the "triggering" effect of the three specified events was, itself, conditioned upon the number of directors approving the underlying transaction. The prospectus, pursuant to which the debentures were advertised, essentially recites *verbatim* the Indenture's description of the right to tender.

As it so happened, the merger at the core of this action was unanimously approved, with one director abstaining, by Wherehouse's Board of Directors. Consequently, plaintiffs' right to tender, which, plaintiffs contend, would have allowed them to redeem the debentures at 106.25% of par, Complaint at ¶ 26, was never triggered. Instead, as plaintiffs allege, the practical effect of the merger—which was accomplished through a leveraged buy-out—left Wherehouse with a debt approaching 90% of its capitalization and left plaintiffs with debentures approximately valued at only 50% of par. *Id.* The gravamen of the present complaint, which followed on the heels of the Wherehouse merger, is that plaintiffs were never made aware that the Independent Directors, without so much as considering the interests of the debentureholders, had the unbridled discretion to approve any one of the specified triggering events and thereby waive plaintiffs' right to tender. Alternatively, plaintiffs argue under state law that the Independent Directors did, indeed, have a contractual obligation to act in the best interests of the debentureholders when approving (or disapproving) any of the triggering events.

On January 15, 1988, plaintiffs commenced the present action alleging, under state law, breach of contract, breach of implied duty of good faith and fair dealing, intentional interference with a contract, and fraudulent conveyance. Only three counts in plaintiffs' Complaint allege causes of action under federal law and, as the R & R indicates, all three are

made expressly conditional on the failure of plaintiffs' claims under state law. R & R at 8. Specifically, Count Three of the Complaint alleges that the prospectus for the debentures, dated July 10, 1986, contained material misstatements and omissions in violation of § 11 of the Securities Act of 1933, 15 U.S.C. § 77k, because it "nowhere suggests that the right to tender is not intended for the benefit of the debentureholders . . . [or] . . . that the Independent Directors may waive the right in a situation where the triggering events adversely affect debentureholders." *Id.* at ¶ 35.

Count Four alleges that defendant Furman Selz, on two occasions, made materially false and misleading statements in connection with the sale of the debentures, in violation of Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 771, when it represented to Thomas Revy, a principal of plaintiff Froley, Revy, that the debentures included a " "special protection for debentureholders" in the event that the Company [Wherehouse] was subject to a takeover," *Id.* at ¶ 42, and a " "protective covenant for the debentureholders" to protect against takeovers." *Id.* at ¶ 43. Plaintiffs contend that in view of these oral representations and the aforementioned statements in the prospectus, "the failure to state that the right to tender could be eliminated in the unrestricted discretion of a majority of the directors constituted an omission to state a material fact necessary in order to make statements made, in light of the circumstances, not misleading." *Id.* at ¶ 46.

Finally, Count Five of the Complaint alleges that the defendants,[1] in violation of § 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j, knowingly or recklessly omitted to state in the registration statements and prospectus "that neither the Company [Wherehouse] nor the Directors had any intention of making the determination whether to waive the right to tender from the standpoint of the debentureholders." *Id.* at ¶ 51.

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1 It should be noted that the only claim asserted against defendant—Chemical Bank is under state law for fraudulent conveyance. *Id.* at ¶ 57.

On February 23, 1988, all of the defendants, with the exception of Chemical Bank, moved to dismiss plaintiffs' complaint pursuant to 12(b)(1) and 12(b)(6) of the Federal Rules of Civil Procedure. On February 29, 1988, defendant Chemical Bank also moved for dismissal under Fed.R.Civ.P. 12(b)(1). As previously noted, the motions were referred to on March 21, 1988. The parties were thereafter advised of Magistrate Robert's intention to treat the 12(b)(6) motion to dismiss as a motion for summary judgment pursuant to Fed.R.Civ.P. 56. Before this Court is the Magistrate's recommendation that summary judgment be granted in favor of the defendants on all of the federal securities claims alleged and that the remaining state law claims be dismissed for lack of subject matter jurisdiction.

DISCUSSION

Summary judgment is appropriate where "there is no genuine issue as to any material fact and . . . the moving party is entitled to judgment as a matter of law." Fed.R.Civ.P. 56(c). As the R & R indicates, summary judgment is generally inappropriate in federal securities cases where the materiality of the alleged misstatement or omission is at issue. R & R at 16. Materiality is a mixed question of law and fact and unless the alleged misstatements or omissions are "so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance," a motion pursuant to Fed.R.Civ.P. 12(b)(6) or 56 should be denied. *Goldman v. Belden*, 754 F.2d 1059 (2d Cir. 1985). The basis for the Magistrate's recommendation that plaintiffs' federal securities claims be dismissed was not, however, her judgment that the alleged omissions and misstatements were immaterial or negligible. Rather, her recommendation was based upon the conclusion that plaintiffs had failed to allege any omission or misstatement—material or otherwise—within the meaning of the federal securities laws.[2] Consequently,

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2 Accordingly, plaintiffs' contention that "[i]t was clear error . . . for the Magistrate to conclude as a matter of law that these omissions are not

there was no need to address the more complicated issue of materiality. R & R at 16-17.

The Magistrate's analysis was premised upon the view that the disclosure required by the federal securities laws "is not a rite of confession or exercise in common law pleading. What is required is the disclosure of *material objective factual matters.*" *Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F.2d 1, 5-6 (2d Cir. 1983), *cert. denied*, 465 U.S. 1052 (1984) (emphasis supplied). The courts of this Circuit have interpreted those laws to require "nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative experience in reaching their own investment decisions." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); *see also Gulf & Western Industries, Inc. v. Great Atlantic & Pacific Tea Co., Inc.*, 476 F.2d 687, 697 (2d Cir. 1973). On the other hand, the disclosure requirements, no matter how broadly construed, do not compel parties, such as the defendants here, to set forth legal conclusions, *Koppel v. Wien*, 575 F.Supp. 960, 968 (S.D.N.Y. 1983), engage in speculation, *Hecco Ventures v. Avalon Energy Corp.*, 606 F.Supp. 512, 519 (S.D.N.Y. 1985), characterize the basic underlying facts with pejorative descriptions or verbalize all adverse inferences expressly. *Klamberg v. Roth*, 473 F.Supp. 544, 551-52 (S.D.N.Y. 1979). In short, the securities laws upon which plaintiffs' claims are premised do not require corporations "to address their stockholders [or other investors] as if they were children in kindergarten." *Richland v. Crandall*, 262 F.Supp. 538, 554 (S.D.N.Y. 1967).

With these basic precepts in mind, we now turn to the specific claims as set forth in the Complaint and as elaborated upon in the accompanying affidavits. For the purposes of her analysis, the Magistrate examined Count Three, under § 11

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material," Plaintiffs' Objections to the Magistrate's Report and Recommendation ("Objections") at 15, plainly misconceives the thrust of the Magistrate's R & R.

of the Securities Act of 1933,[3] and Count Five, under § 10(b) of the Securities Exchange Act of 1934,[4] together. This Court concurs in that analytical approach, not simply because the relevant portions of both provisions impose civil liability for material omissions in virtually identical language,[5] but also because the omissions alleged in both counts are, themselves, virtually identical. Count Three alleges at various portions that the prospectus was materially misleading because it nowhere "suggests that the Independent Directors may waive the right [to tender] in a situation where the triggering events adversely affect debentureholders" and nowhere "discloses that the Independent Directors' fiduciary duties to the Company's shareholders might conflict and interfere with the debentureholders' contractual right to tender." Complaint at ¶ 35. Count Five similarly alleges that defendants willfully

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3 Section 11 provides in relevant part:

(a) In case any part of the registration statement . . . contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security . . . may . . . sue—

(1) every person who signed the registration statement;

(2) every person who was a director . . . or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted.

4 Section 10(b) provides, in relevant part:

It shall be unlawful for any person, . . . by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

5 *See Rubin v. Long Island Lighting Co.*, 576 F.Supp. 608, 612 (E.D.N.Y. 1984) (both provisions "stand or fall together," because liability under both is premised on the making—in a registration statement or prospectus—of a material misstatement or omission. However, section 10(b) does require, in addition, a showing of scienter.)

omitted to state in the registration statement and prospectus that "neither the Company nor the Directors had any intention of making the determination whether to waive the right to tender from the standpoint of the debentureholders." *Id.* at ¶ 51.

The essence of plaintiffs' grievance under both of these counts is that plaintiffs were never informed that the conditional right to tender did *not* carry with it something in the way of a fiduciary obligation on the part of the directors to act in the best interests of the debentureholders. Indeed, as the Complaint makes plain, the success of these federal claims is predicated upon the very failure of plaintiffs' claims under state law which allege, conversely, that the right to tender did, in fact, give rise to such a contractual fiduciary duty. The thrust of plaintiffs' argument thus appears to be that if, under state law, no fiduciary duty on the part of the directors existed, then the defendants, under the federal securities laws, were obligated to so inform the plaintiffs.

We agree with the Magistrate that statements of this nature would amount to legal conclusions and characterizations which, under the federal securities laws, defendants were in no way obligated to provide. R & R at 19-20; *see Koppel*, 575 F.Supp. at 968. Indeed, in faulting the Prospectus for "assum[ing], among other things, legal knowledge (both as a matter of contract interpretation and corporate law), that the so-called "Independent Directors" owed no duty to the debentureholders," plaintiffs' Objections to the R & R underscore the very legal nature of the characterizations they claim the defendants were obligated to make. Objections at 6 ("Nor does it [the prospectus] explain that the fiduciary duties of the so-called "Independent Directors" are owed solely to the company's shareholders, not the debentureholders"). *See also Id.* at 17-18 ("Here . . . the company refused to disclose the known legal effect of the debentureholders' alleged right to tender . . .").[6]

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6 To the extent plaintiffs' allegation in Count Five might be distinguished from the allegations in Count Three to mean that defendants deliber-

Plaintiffs' further allegation in Count Three and Five that neither the prospectus nor Wherehouse and/or its directors disclosed that the right to tender "*might* be illusory," suffers from similar deficiencies. Complaint at ¶¶ 36 and 48 (emphasis supplied). While plaintiffs' right to tender may not have been, from plaintiffs' point of view, "worth a bucket of warm spit"[7] because "over 90% of all acquisitions (including hostile takeovers) are conducted with the agreement of the pre-existing directors,"[8] the federal securities laws by no means require the basic underlying facts of plaintiffs' right to tender to be cast in such pejorative terms. *Goldberg v. Meridor*, 567 F.2d 209, 218 n.8 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978) (Section 10(b) does not require transactions to be characterized by pejorative nouns or adjectives); *Klamberg*, 473 F.Supp. at 551-52.

At any rate, required disclosure of the operational value of the right to tender, with or without the pejorative characterizations, would have compelled the defendants in the instant case to speculate, not merely upon the number of triggering events likely to be forthcoming, but also upon the likelihood that those prospective events would be approved by a majority of the Independent Directors. As previously noted, the federal securities laws do not go so far as to affirmatively mandate predictions on the part of issuers, particularly predictions of this magnitude. *Hecco Ventures*, 606 F.Supp. at 519 ("the material facts were disclosed, and the parties had no obligation to offer additional speculation . . . "); The

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ately misled plaintiffs into thinking they would act in a fiduciary capacity, while, all along, defendants never intended to so act, the allegation must nevertheless be dismissed for failure to state a claim. As this Circuit has noted previously, while the "making [of] a specific promise to perform a particular act in the future while secretly not intending to perform that act may violate Section 10(b) where the promise is part of the consideration . . . [s]uch a promise . . . must encompass particular actions and be more than a generalized promise to act as a faithful fiduciary." *Luce v. Edelstein*, 802 F.2d 49, 55 (2d Cir. 1986); *see also Pross v. Katz*, 784 F.2d 455, 457-58 (2d Cir. 1986).

7 Letter to the Court dated November 3, 1988.

8 Letter to the Court dated June 14, 1988.

extent of the benefit provided by the right to tender was a determination which plaintiffs, cognizant of the basic underlying facts and drawing upon their own evaluative experience, should have made for themselves. The securities laws do not require issuers to make such forecasts for them.[9] *Billard; v. Rockwell International Corp.*, 526 F.Supp. 218, 221 (S.D.N.Y. 1981) ("matters of prediction or speculation" need not be disclosed; "securities laws require only the disclosure of basic facts so that [others] may draw upon their own evaluative expertise"), *aff'd*, 683 F.2d 51 (2d Cir. 1982); *Straus v. Holiday Inns, Inc*, 460 F.Supp. 729 (S.D.N.Y. 1978).

Finally, in Count Four of the Complaint, plaintiffs allege that, during the summer of 1986, in a telephone conversation with Thomas Revy ("Revy")—a principal of plaintiff Froley, Revy—Sean Gallagher, a representative of defendant Furman Selz, characterized the debentures as including a " "special protection for debentureholders" in the event that the Company was subject to a takeover." Complaint at ¶ 14; *see also* Affidavit of Thomas Revy ("Revy Affidavit") at ¶ 3. Count Four further alleges that at a subsequent "due diligence" luncheon, "various officers" of Furman Selz stated to Revy that the debentures contained a " "protective covenant for the debentureholders" to protect against takeovers." Complaint at ¶ 43; *see also* Revy Affidavit at ¶ 4. Plaintiffs contend that, in light of defendants' subsequent assertion that the right to tender could be eliminated in the unrestricted discretion of the directors, the aforementioned statements were both materially false and, in conjunction with the prospectus, contained material omissions—all in violation of Section 12(2) of the Securities Act of 1933.

Despite defendants' urging, this Court hesitates to characterize these statements as mere puffing, and nothing more, though these remarks do appear to occupy the somewhat murky region between encouraging characterization and state-

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9 Indeed, *Beecher v. Able*, 374 F.Supp. 341 (S.D.N.Y. 1971), which is cited by plaintiffs in their Objections, underscores the very reason why an issuer may altogether eschew such prognostications, for in making forecasts, the issuer may also expose itself to additional liability for misleading disclosures.

ment of fact. *See, e.g., Klamberg*, 473 F. Supp. at 552 ("Of course, the distinction between facts and characterizations [or opinions] may not be a nice one"). Assuming for the purposes of this motion, however, that these remarks were intended to be statements of fact, and were accepted as such, we agree with the Magistrate that the plaintiffs have nevertheless failed to allege a "single untrue statement—material or otherwise—" within the purview of section 12(2).[10] R & R at 27. Under the conditions specified in both the Indenture and the prospectus, and particularly where the company might find itself subjected to an hostile takeover, the right to tender could, indeed, be "protective" of the debentureholders' interests. Finally, failure, on the part of the Furman Selz representatives, to elaborate upon the duties created by the right to tender no more constitutes an omission within the meaning of the securities laws than does the absence of such instruction in the prospectus or Indenture. Indeed, as the Magistrate indicated, this argument amounts to nothing more than a reassertion of the claims set forth in Counts Three and Five. R & R at 29.

Accordingly, because plaintiffs' federal claims fail to allege any omission or misstatement of fact—material or otherwise—within the meaning of the securities laws, they are dismissed pursuant to Fed.R.Civ.P. 56. Plaintiffs state law claims are dismissed for lack of pendent jurisdiction. *Walker v. Time Life Films, Inc.*, 784 F.2d 44, 53 (2d Cir.), *cert. denied*, 476 U.S. 1159 (1986) (absent exceptional circumstances, dismissal of state claims for lack of pendent jurisdiction is the recommended procedure in cases where all federal claims are disposed of prior to trial).

It Is So Ordered.

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10 Section 12(2) imposes liability upon any person who:

> offers to sell or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . .

Dated: New York, New York
May 22, 1989

/s/ MARY JOHNSON LOWE
United States District Court

Magistrate's Report & Recommendation

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

88 Civ. 0321 (MJL)

MCMAHAN & COMPANY, FROLEY, REVY INVESTMENT CO., INC. and WECHSLER & KRUMHOLZ, INC.,

Plaintiffs,

—against—

WHEREHOUSE ENTERTAINMENT, INC., LOUIS A. KWIKER, GEORGE A. SMITH, MICHAEL T. O'KANE, LAWRENCE K. HARRIS, DONALD E. MARTIN, JOEL D. TAUBER, FURMAN SELZ MAGER DIETZ & BIRNEY INCORPORATED, WEI ACQUISITION CORP., WEI HOLDINGS, INC., ADLER & SHAYKIN, and CHEMICAL BANK,

Defendants.

TO THE HONORABLE MARY JOHNSON LOWE:

Plaintiffs commenced this action on January 15, 1988, alleging breach of contract and violations of the federal securities laws in connection with the sale of convertible subordinated debentures; an amended complaint was filed on January 22. On January 27, plaintiffs moved for an order granting expedited discovery, and, on February 2, Your Honor referred the case to me for the supervision of pretrial discovery. By Order dated February 4, I denied plaintiffs' motion for expedited discovery and directed the parties to complete the requested discovery by April 1. That Order was specifically without prejudice to defendants' right to move for a stay of discovery in connection with the filing of a motion to dismiss the amended complaint.

On February 23, defendants Wherehouse Entertainment Inc., *et al.*,[1] moved for an order dismissing plaintiffs' amended complaint pursuant to Rules 12(b)(1) and 12(b)(6) of the Federal Rules of Civil Procedure and for a protective order staying discovery pending resolution of the motion to dismiss. On February 29, defendant Chemical Bank submitted a separate motion for dismissal under Rule 12(b)(1) for lack of jurisdiction over the subject matter. On March 9, plaintiffs submitted an "answering memorandum" and supporting affidavits in opposition to defendants' motions to dismiss the complaint. Defendants filed their reply on March 11.

On March 21, Your Honor referred defendants' motions to dismiss and for a protective order to me for Report and Recommendation. On March 22, the parties appeared before me and presented oral argument on the motion for a stay of discovery pending resolution of the motions to dismiss. By Order dated March 24, I granted defendants' motion to stay discovery pending resolution of the motions to dismiss.

At a conference on June 9, I advised the parties of my intention to treat defendants' 12(b) (6) motion to dismiss as a motion for summary judgment under Rule 56, Fed. R. Civ. P.,[2] and invited the parties to make any further submissions to the Court they deemed necessary and appropriate. I also expressed my view that plaintiffs had failed adequately to allege the factual bases for their federal securities-fraud claims.

On June 14, plaintiffs submitted a "Revised Amended Complaint" supplementing their fraud claims and adding a claim for damages under Section 12(2) of the Securities Act

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1 All defendants joined in this motion with the exception of Chemical Bank.

2 Conversion was proper, in my view, because plaintiffs had submitted a number of affidavits in opposition to defendants' motion, and because certain documents germane to the resolution of the lawsuit (an Indenture Agreement and Prospectus) were neither appended to nor specifically incorporated by reference in the amended complaint. *See Goldman v. Belden*, 754 F.2d 1059 (2d Cir. 1985).

of 1933, 15 U.S.C. § 77L. In response, defendants submitted a letter to the Court dated June 30, addressing the effect of the latest amendments on their pending motion. The parties have since represented to the Court that they do not intend to make any further submissions in connection with the summary judgment motion.

Plaintiffs claim that they are entitled to relief under both state and federal law. For the reasons set forth below, I find that there are no genuine issues of fact with respect to plaintiffs' federal securities claims and that defendants are entitled to judgment on these claims as a matter of law. I further find that, in the absence of a valid federal cause of action, it would be inappropriate to exercise pendent jurisdiction over the remaining state-law claims. I accordingly recommend that the federal claims be dismissed pursuant to Fed. R. Civ. P. 56 and that the state claims be dismissed pursuant to Fed. R. Civ. P. 12(b)(1).

BACKGROUND

Plaintiffs are financial institutions that are the record owners of certain convertible subordinated debentures of defendant Wherehouse Entertainment, Inc. ("Wherehouse").[3] On December 20, 1987, Wherehouse's Board of Directors unanimously approved (with one Director abstaining) a merger

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3 There are eleven named defendants. Wherehouse is a Delaware corporation that owns and operates a large number of record stores in the Western United States. *See* Revised Amended Complaint ¶ 9. Defendant Louis A. Kwiker is Chief Executive Officer, President, and a director of Wherehouse. *Id.* ¶ 10. Defendants George A. Smith, Donald E. Martin, Joel D. Tauber, Michael T. O'Kane, and Lawrence K. Harris all are directors of Wherehouse. *Id.* ¶¶ 11-15. (The term "Independent Directors" refers to all of the individual defendants named above with the exception of Kwiker.) Defendant WEI Acquisition Corp. is a wholly owned subsidiary of defendant WEI Holdings, Inc. *Id.* ¶ 17. Defendant WEI Holdings, Inc., is owned by defendant Adler & Shaykin, a partnership located in New York City. *Id.* ¶ 17. Defendant Furman Selz Mager Dietz & Birney, Incorporated ("Furman Selz"), is a corporation with its principal place of business in New York City. *Id.* ¶ 18. Finally, defendant Chemical Bank is a New York City banking corporation. *Id.* ¶ 19.

agreement with defendants WEI Acquisition Corp. ("Acquisition") and WEI Holdings ("Holdings"). Pursuant to that agreement, on December 23, 1987, Acquisition commenced a tender offer for any and all shares of Wherehouse common stock at fourteen dollars per share. This offer closed on January 22, 1988, at which time over 90 percent of the shares were tendered and purchased. Acquisition has since been merged into Wherehouse.[4]

Plaintiffs' claims in this case are based on a special "right to tender" provided to debentureholders in the governing Indenture. *See* Revised Amended Complaint ¶¶ 2, 3; Exhibit A to Memorandum of Law in Support of Defendants' Motion to Dismiss the Amended Complaint and for a Protective Order Staying Discovery ("Def. Memo") (Indenture dated June 15, 1986, between Wherehouse and Bank of America National Trust and Savings Association). Section 5.02 of the Indenture provides, *inter alia*, that, if certain specifically defined "triggering events" occur, the debentureholders will have the right to sell their debentures to Wherehouse at a set redemption price. *See id.* at 11-12. The three types of triggering events are defined as follows:

> (a) A person or group * * * shall attain the beneficial ownership * * * of an equity interest representing at least 80% of the voting power for election of the Board of Directors of the Company *unless such attainment has been approved by a majority of the Independent Directors*;
>
> (b) The Company * * * consolidates or merges with any other person * * * *unless approved by a majority of the Independent Directors*;
>
> (c) The Company or any Subsidiary incurs, issues, assumes, guarantees or creates any Debt, or pledges any Company or Subsidiary assets to secure repay-

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4 Although the parties advised the Court that the merger took place shortly after the action was filed on January 15, 1988, plaintiffs' Revised Amended Complaint continues to make reference to "the proposed merger." *See id.* ¶¶ 23, 27, 50, 57.

> ment of any Debt, *excluding Debt existing on July 9, 1986 and Debt which is authorized or ratified by a majority of the Independent Directors* * * *.

Id. (emphasis supplied).

Although plaintiffs concede that the Independent Directors approved the merger of Acquisition and Wherehouse, *see* Revised Amended Complaint ¶ 25, they contend that the Independent Directors breached a "contractual obligation" to consider the "best interest of the debentureholders" by approving the merger and thus waiving the debentureholders' conditional right under the Indenture to redemption. *See* Revised Amended Complaint ¶¶ 24-25; Plaintiffs' Answering Memorandum ("Pl. Memo") at 4-40. They claim that "[t]he transaction * * * trigger[ed] all three of the events set forth in the right to tender, * * * leav[ing the company] with insufficient cash flow and underlying capital to provide adequate security for the holders of the Subordinated Debentures." Revised Amended Complaint ¶ 23. As a result of the merger, plaintiffs claim that Wherehouse's debt will approach 90 percent of its capitalization, and that the debentureholders will lose their right to redeem the debentures at 106.25 percent of par, and will instead be left with bonds valued at approximately 50 percent of par. *Id.* at ¶ 26. In their memorandum to the Court, plaintiffs represent that "[t]he loss to all the debentureholders totals over $28 million (or over half the investment made only 20 months ago)." Pl. Memo at 2.

Counts One, Two, Six, and Seven are predicated on state law; jurisdiction for these claims is based on the doctrines of pendent and ancillary jurisdiction. *See* Revised Amended Complaint ¶ 4. Count One alleges that, by approving the merger (and thereby waiving the debentureholders' conditional right to redemption), the Independent Directors "breached the obligations and duties to the debentureholders created under the Indenture." *Id.* ¶ 25. Count Two alleges that the decision by the Independent Directors to approve the merger "breached the [Independent Directors'] contractual obligation to deal fairly and in good faith with the debentureholders." *Id.* ¶ 31. Count Six alleges that the defendants

"knowingly interfered" with the debentureholders' contractual "right to tender." *Id.* ¶ 53. Count Seven, the last of plaintiffs' state-law claims, alleges that "[t]he Merger * * * constitute[s] the incurrence of an obligation and a conveyance without fair consideration under applicable fraudulent conveyance statutes." *Id.* ¶ 57.[5]

Counts Three, Four, and Five of the Revised Amended Complaint allege violations of the federal securities laws and are made expressly conditional on the *failure* of plaintiffs' claims under state law. Count Three states that, "[i]f it is determined, *contrary to plaintiffs' position*, that the directors *could* properly waive the right to tender on a transaction that materially injures the debentureholders, then plaintiffs are entitled to damages against Wherehouse, the Directors and defendant Furman Selz, based on material omissions in the Registration Statement for the Debentures and in the prospectus for the Debentures dated July 10, 1986 (the 'Prospectus')." *Id.* ¶ 33 (emphases supplied). Plaintiffs argue that, since "[t]he Prospectus nowhere suggests that the right to tender is not intended for the benefit of the debentureholders * * * [or] * * * that the Independent Directors may waive the right in a situation where the triggering events adversely affect debentureholders" (*id.* ¶ 35), the Prospectus "contained material misstatements and omissions" in violation of

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5 Count Seven is asserted against all defendants including Chemical Bank; it is the *only* claim asserted against Chemical Bank. In Count Seven, plaintiffs claim that the merger violated "applicable fraudulent conveyance statutes" because:

> (i) In the proposed Merger, Wherehouse will be combined with a shell entity with enormous debt provided by Chemical Bank, which will be secured by Wherehouse assets, without Wherehouse's receiving therefor, in good faith, fair equivalent property; (ii) The Merger will render Wherehouse insolvent and leave Wherehouse with property remaining in its hands that is an unreasonably small capital to meet its obligations to debentureholders and other creditors; and (iii) Wherehouse intends or believes that by reason of the Merger it will incur debts beyond its ability to pay them as they mature.

Revised Amended Complaint ¶ 57.

§ 11 of the Securities Act of 1933, 15 U.S.C. § 77k.[6] *Id.* ¶¶ 38, 40.

Count Four, set forth for the first time in plaintiffs' Revised Amended Complaint, alleges a violation of Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77L.[7] As with Count Three, Count Four arises only upon the failure of plaintiffs' claim that the Independent Directors were obligated to consider the debentureholders' best interests before waiving the right to redeem. Count Four alleges that various

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6 Section 11 provides, *inter alia*:

> (a) In case any part of the registration statement . . . contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security * * * may * * * sue—
>
> (1) every person who signed the registration statement;
>
> (2) every person who was a director of * * * or partner in the issuer at the time or the filing of the part of the registration statement with respect to which his liability is asserted; * * *
>
> If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission * * *.

7 Section 12(2) provides, *inter alia*:

Any person who—

> (2) offers or sells a security * * * by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, * * * to recover the consideration paid for such security with interest thereon, * * * upon the tender of such security, or for damages if he no longer owns the security.

officers and representatives of defendant Furman Selz orally represented to plaintiffs that the debentures contained a "protective covenant" for the debentureholders to protect against takeovers; that "[t]hese oral representations, along with statements contained in the prospectus, led [plaintiff] Revy to believe that the purpose of the right to tender was to protect debentureholders and that his investment would be returned to him in the event the harmful effects of a merger or excess debt occurred"; and that "Furman Selz's statements were materially false and misleading in light of defendants' subsequent assertion that the right to tender may be eliminated in the unrestricted discretion of the Independent Directors." Revised Amended Complaint ¶¶ 42-46.

Count Five, the last of the federal securities claims, alleges that "[t]he Company * * * knowingly omitted to state in the Registration Statement and Prospectus, or omitted to do so with reckless disregard for the interests of purchasers of the Debentures, that neither the Company nor the Directors had any intention of making the determination whether to waive the right to tender from the standpoint of the debentureholders." *Id.* ¶ 51. Plaintiffs claim that "[t]his willful and material omission operated as a fraud upon and injured plaintiffs" (*id.*), in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j.[8]

Defendants argue that Counts One through Six of the Revised Amended Complaint should be dismissed on the merits.[9] Defendants' challenge to the state-law causes of action

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8 Section 10(b) of the Securities Exchange Act of 1934 provides:

It shall be unlawful for any person, * * * by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

9 Count Seven (the fraudulent conveyance claim) is the only cause of action not challenged by defendants' Rule 12(b)(6) motion to dismiss.

(Counts One, Two, and Six) is premised on a literal reading of the Indenture, which provides that the debentureholders' right to tender shall be triggered upon the occurrence of any of three types of transactions or events, *unless a majority of the Independent Directors*[10] *approves that transaction.* According to defendants, this language gives the Independent Directors the "unrestricted discretion to approve or disapprove any potentially 'triggering' transaction based on their own business judgment." Def. Memo at 6. Since Wherehouse's Independent Directors unanimously approved the merger between Wherehouse and Acquisition, defendants argue that plaintiffs have no valid causes of action for breach of contract (Count One), breach of the duty of good faith and fair dealing (Count Two), or intentional interference with contract (Count Six).[11]

With respect to the federal claims (Counts Three, Four, and Five), defendants argue that the rights of the parties under the Indenture were completely and accurately disclosed in both the Indenture and the Prospectus. *See* Def. Memo at 5-7. Given the clarity of the Indenture and the Prospectus, defendants argue that the failure expressly to state in the Prospectus that the Independent Directors could waive the redemption right without regard to the best interests of the debentureholders cannot be viewed as a "material omission" within the meaning of the federal securities laws. Defendants argue further that, contrary to plaintiffs' position, the condi-

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10 Under Section 5.02, " '*Independent Director*' means a director of the Company who is not, and has not been during the 5 years prior thereto, an employee of the Company and who either was a member of the Board of Directors of the Company on July 10, 1986, or who subsequently became a director of the Company and whose election, or nomination for election, by the Company's shareholders was approved by a vote of a majority of the Independent Directors then on the Board of Directors." Def. Memo Exhibit A at 12.

11 Defendants specifically argue that Count I must fail because the Independent Directors approved this transaction and thus the right to redeem was never triggered; Count II must fail because this doctrine cannot be used to create rights inconsistent with or at variance with the rights spelled out in the Indenture; and Count V must fail because no one interfered with any right that is actually contained in the Indenture. *See* Def. Memo at 5, 7.

tional redemption right provides a valuable benefit to debentureholders in the event that Wherehouse is subject to a hostile takeover. Defendants therefore argue that there was nothing false or misleading in representing to plaintiffs that the debentures contained a covenant for the benefit of the debentureholders.

Defendants also have moved to dismiss all of plaintiffs' state-law claims (Counts One, Two, Six, and Seven) pursuant to Fed. R. Civ. P. 12(b)(1) on the ground that this Court should not exercise pendent jurisdiction over the state-law causes of action absent a valid federal claim. *See* Def. Memo at 27-31. In a separate 12(b)(1) motion to dismiss, defendant Chemical Bank argues that Count Seven should be dismissed for lack of pendent-party jurisdiction. *See* Chemical Bank's Memorandum of Law filed in Support of Motion to Dismiss ("Chem. Memo"); Reply Memorandum in Further Support of Defendant Chemical Bank's Motion to Dismiss ("Chem. Reply").

DISCUSSION

Summary judgment may be granted only where "there is no genuine issue as to any material fact and * * * the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c). *See also Anderson v. Liberty Lobby*, 477 U.S. 242, 106 S. Ct. 2505, 2511 (1986); *Lopez v. S.B. Thomas, Inc.*, 831 F.2d 1184, 1187 (2d Cir. 1987). The burden rests on the moving party to demonstrate the lack of a genuine issue of fact, *Adickes v. S.H. Kress & Co.*, 398 U.S. 144, 157 (1970); *Clements v. Nassau County*, 835 F.2d 1000, 1004 (2d Cir. 1987); *Donahue v. Windsor Locks Board of Fire Commissioners*, 834 F.2d 54, 57 (2d Cir. 1987); *Williams v. Smith*, 781 F.2d 319, 323 (2d Cir. 1986); *Heyman v. Commerce & Industry Insurance Co.*, 524 F.2d 1317, 1320 (2d Cir. 1975), and the record must be viewed in the light most favorable to the party opposing the motion. *United States v. Diebold, Inc.*, 369 U.S. 654, 655 (1962); *Knight v. United States Fire Insurance Co.*, 804 F.2d 9, 11 (2d Cir. 1986), *cert.*

denied, 107 S. Ct. 1570 (1987). There must also be no controversy as to the inferences to be drawn from the facts, and the court must resolve all ambiguities and draw all inferences against the moving party. *Wakefield v. Northern Telecom, Inc.*, 813 F.2d 535, 540 (2d Cir. 1987); *EEOC v. Home Insurance Co.*, 672 F.2d 252, 256-57 (2d Cir. 1982); *American International Group Inc. v. London American International Corp.*, 664 F.2d 348, 351 (2d Cir. 1981).

Not all alleged factual disputes will defeat a motion for summary judgment; "the requirement is that there be no *genuine* issue of *material* fact." *Anderson*, 477 U.S. at 248 (emphasis in original). Material facts are determined by the substantive law underlying the action: "[o]nly disputes over facts that might affect the outcome of the suit under the governing law will properly preclude the entry of summary judgment." *Id.*; *see also Knight*, 804 F.2d at 11-12; *Quarles v. General Motors Corp.*, 758 F.2d 839, 840 (2d Cir. 1985).

While the burden of demonstrating the absence of any genuine issues of material fact is a difficult one to meet, motions for summary judgment, when properly employed, permit a court to terminate frivolous claims and to concentrate its resources on meritorious litigation. *Knight*, 804 F.2d at 12. As the Supreme Court has stated, a motion for summary judgment is properly regarded as:

> an integral part of the Federal Rules as a whole, which are designed 'to secure the just, speedy and inexpensive determination of every action' * * * Rule 56 must be construed with due regard not only for the rights of persons asserting claims and defenses that are adequately based in fact * * *, but also for the rights of persons opposing such claims and defenses to demonstrate in the manner provided by Rule, prior to trial, that the claims and defenses have no factual basis.

Celotex Corp. v. Catrett, 477 U.S. 317, 327 (1986).

Although summary judgment ordinarily is inappropriate in federal securities cases involving alleged misstatements or

omissions of material fact,[12] I find that plaintiffs here have failed even to make a *threshold* showing of an affirmative misrepresentation or omission within the meaning of the federal securities laws. It is therefore unnecessary to consider the potential significance of the alleged misstatements or omissions in the mind of a "reasonable investor." Because the issue of materiality never arises, I find that there are no genuine issues of disputed fact barring entry of summary judgment for the moving party.[13]

Federal Securities Claims:

Plaintiffs' claims under the federal securities laws allege both omissions and affirmative misrepresentations with respect to the debentureholders' conditional right to tender under Section 5.02 of the Indenture. Counts Three and Five concern alleged omissions in the Prospectus. Count Three under Section 11 of the 1933 Act essentially claims that the Prospectus was materially misleading because it omitted to state that the Independent Directors may waive the right to

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12 Under the federal securities laws, the materiality of an alleged misstatement or omission is a "mixed question of law and fact * * *." *Goldman v. Belden*, 754 F.2d 1059, 1067 (2d Cir. 1985); *see also TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976). In *Goldman*, the Second Circuit held that "a complaint may not properly be dismissed pursuant to Rule 12(b)(6) (or even pursuant to Rule 56) on the ground that the alleged misstatements or ommission are not material unless they are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance." *Goldman*, 754 F.2d at 1067; *see also Kronfeld v. Trans World Airlines, Inc.*, 832 F.2d 726, 731 (2d Cir. 1987), *cert. denied*, 108 S. Ct. 1470 (1988); *GAF Corp. v. Heyman*, 724 F.2d 727, 737 (2d Cir. 1983); *Seibert v. Sperry Rand Corp.*, 586 F.2d 949, 951 (2d Cir. 1978); *Joyce v. Joyce Beverages, Inc.*, 571 F.2d 703, 707 (2d Cir.), *cert. denied*, 437 U.S. 905 (1978); *Mendell v. Greenberg*, 612 F. Supp. 1543, 1548-49 (S.D.N.Y. 1985).

13 The only "fact issues" alleged by plaintiff concern the materiality of the alleged omissions and misstatements in the mind of a "reasonable investor." *See* Pl. Memo at 38-39. However, since I find that plaintiffs have failed to allege any omissions or misstatements within the meaning of the federal securities laws, it is unnecessary to reach the materiality question: plaintiffs' claims are simply inadequate as a matter of law.

tender in a situation where the triggering events adversely affect debentureholders. *See* Revised Amended Complaint ¶ 35. Count Five incorporates by reference the alleged omissions described in Count Three and, in recognition of the scienter requirement of Rule 10(b) of the 1934 Act,[14] additionally alleges that the Prospectus was misleading because it omitted to state that "neither the Company nor the Directors had any intention of making the determination whether to waive the right to tender from the standpoint of the debentureholders." *See id.* ¶ 51. Count Four under Section 12(2) of the 1933 Act alleges both affirmative oral statements and omissions on the part of representatives and officers of defendant Furman Selz misrepresenting the extent to which the conditional redemption right would protect the debentureholders in the event of a merger.

Since plaintiffs' federal claims arise only if the state-law claims are rejected,[15] my analysis of the federal claims proceeds from the assumption that the Independent Directors in fact had the unrestricted discretion to "waive" the conditional-redemption right provided by Section 5.02 of the Indenture. Given this assumption, the first question is whether the lack of an explicit reference in the Prospectus to

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14 Both Section 11 of the Securities Act of 1933 and Section 10(b) of the Securities Exchange of 1934 require a plaintiff to allege and prove that a registration statement or prospectus contained a misstatement or omitted to state a material fact necessary to make the statements made not misleading. *See Rubin v. Long Island Lighting Co.*, 576 F. Supp. 608, 612 (E.D.N.Y. 1984). The difference between the two provision is that, unlike Section 11, Section 10(b) and accompanying Rule 10(b) (5) require a showing of scienter. *See id.* at 612 n.7; *see also Elfenbein v. American Financial Corp.*, 487 F. Supp. 619, 626 (S.D.N.Y. 1980), *aff'd*, 652 F.2d 53 (2d Cir. 1981).

15 As noted above, the federal claims are predicated on the failure of plaintiffs' claims under state law: this is because success on the common-law claims depends on a showing that the Independent Directors *were* subject to an express or implied duty to consider the debentureholders' best interests before waiving the conditional right to redeem provided under Section 5.02 of the Indenture. In the event of such a showing, there could be no claim that the Prospectus is misleading along the lines suggested by plaintiffs. Nor could plaintiffs argue that there was anything misleading about the Furman Selz representatives' assurances that the Indenture contained a protective covenant for the debentureholders' benefit.

the "unrestricted discretion" of the Independent Directors constitutes an omission within the meaning of the federal securities laws.

I conclude that it does not. The Prospectus expressly states that the right to redemption is *not* triggered if a majority of the Independent Directors approves the transaction; the language of the Prospectus is clear, unequivocal, and virtually identical to the above-quoted language of Section 5.02 of the Indenture. *See* Def. Memo Exhibit B at 3, 26.[16] Although is it true that "[t]here is no reference [in the Prospectus] to 'unrestricted discretion' or to the standard to be used by the Independent Directors" (Pl. Memo at 31), "legal conclusions or characterizations" do not constitute omissions within the meaning of the securities laws. *Koppel v. Wien*, 575 F. Supp. 960, 967-68 (S.D.N.Y. 1983) (failure to disclose that aspects of proposal set forth in proxy solicitation violated state or federal law not omissions within the contemplation of Section 14(a) of the 1934 Act), *aff'd in part and rev'd in part*, 743 F.2d 129 (2d Cir. 1984) (reversing summary dismissal of plaintiffs' motion for attorney's fees). *See also Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F.2d 1, 5-6 (2d Cir. 1983) (the disclosure required by the federal securities laws is not a "rite of confession or exercise in common law pleading. What is required is the disclosure of *material objective factual matters*") (emphasis supplied), *cert. denied*, 465 U.S.

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16 In describing the "Optional Debenture Tender," the Prospectus specifically provides that the debentureholders will have the option to require the Company to redeem such debentures:

> in the event that: (i) any person or group * * * attains beneficial ownership . . . of at least 80% of the voting power for election of the Company's directors *unless approved by a majority of the Company's Independent Directors*; (ii) the Company consolidates with, merges into or sells or leases its properties and assets substantially as an entirety to any person or entity, *unless approved by a majority of the Company's Independent Directors*; or (iii) the Company or any Subsidiary incurs Debt (*excluding * * * Debt authorized or ratified by a majority of the Company's Independent Directors*).

Def. Memo Exhibit B at 25-26 (emphasis supplied). *See also id.* at 3 (Prospectus Summary; virtually identical language).

1052 (1984);[17] *Gulf & Western Industries, Inc. v. Great Atlantic & Pacific Tea Co., Inc.*, 476 F.2d 687, 697 (2d Cir. 1973) ("the disclosure requirements of the securities laws require 'nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative experience in reaching their own investment decisions' ") (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969)); *Nemo v. Allen*, 466 F. Supp. 192, 195 (S.D.N.Y. 1979) (claims asserted under Sections 13(a) and 14(a) of the 1934 Act dismissed because proxy materials disclosed all facts pertaining to former president's illegal activities and because "[t]here is simply no requirement in the Securities Laws * * * that [the former president's] actions be characterized as criminal in nature. All that need be disclosed are the facts from which a stockholder may draw its own conclusion").[18] As for plaintiffs' claim that the Prospectus "gave the misleading impression that the right

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17 In *Data Probe*, plaintiff Data Probe, Inc., ("Data Probe") sued to enjoin the merger of defendants CRC Acquisition Corp. ("CRC") and Datatab, Inc. ("Datatab"). In its complaint, Data Probe, which was itself attempting to gain control of Datatab through a tender offer, alleged, *inter alia*, that a letter written by Datatab to its shareholders recommending that the shareholders not tender their shares in response to the Data Probe tender offer violated the disclosure requirements of Section 14(e) of the Securities Exchange Act of 1934. Plaintiff alleged that the letter misleadingly failed to disclose that an outstanding option to purchase Datatab's shares held by defendant CRC would, if exercised, effectively guarantee that CRC could acquire Datatab regardless of how many of the outstanding shares were tendered to Data Probe. The trial court found that the letter violated Section 14(e) because, although the letter clearly described the terms of the CRC option to purchase Datatab's shares, it "drew no explicit connection between the grant of the option and the likely outcome of the struggle for control of Datatab." *Id.*, 722 F.2d at 3-5. The Second Circuit reversed, holding that management had satisfied its disclosure obligations by describing the terms of the CRC option to purchase Datatab shares in the letter to Datatab shareholders. *See id.* at 6.

18 As defendants correctly point out, the cases cited by plaintiffs in support of their federal securities claims are inapplicable here, because, in each of those cases, the defendants had made statements that obfuscated the objective facts or had omitted material facts. *See, e.g., Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1295-98 (2d Cir. 1973) (proxy statement found

to tender gave debentureholders protection against mergers and highly leveraged transactions," this argument ignores the fact that the right to tender *does* indeed provide a real benefit to debentureholders in the event that Wherehouse is subjected to a hostile takeover.[19] Indeed, the "antitakeover effect" of the right to tender provision is specifically described in the Prospectus immediately following the description of the "Optional Debenture Tender." *See* Def. Memo Exhibit B at 26-27. Finally, there is no merit to plaintiff's challenge to the Prospectus on the ground that it fails to state that "neither the Company nor the Directors had any intention of making the determination whether to waive the right to tender from the standpoint of the debentureholders." Revised Amended Complaint ¶ 51. Whatever the nature of defendants' intention with respect to the optional-tender provision, failure to disclose "underlying motives" does not constitute an omis-

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to be misleading because it falsely implied that defendant was not planning to sell its remaining outdoor advertising plants); *SEC v. First American Bank & Trust Co.*, 481 F.2d 673, 678-79 (8th Cir. 1973) (statement by financial institution that it was insured was materially misleading since its insurance was insufficient to insure the safety of the deposit, trust and contingent liabilities); *Hundahl v. United Benefit Life Insurance Co.*, 465 F. Supp. 1349, 1365 (N.D. Tex. 1979) (failure to disclose existence of restrictions on dividend declarations could have created liability under Rule lOb-5); *Beecher v. Able*, 374 F. Supp. 341, 346-47 (S.D.N.Y. 1974) (a statement by an issuer that substantial profits were improbable was held to be misleading since a reasonable investor would have concluded that substantial losses were also improbable); *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 574-75 (E.D.N.Y. 1971) (failure to include an estimate of $100,000,000 surplus held to be misleading).

19 As defendants correctly point out in their reply memorandum to the Court, "the express language [of the Indenture] provides the quite valuable right to redemption at par in the event of certain transactions not approved by the Independent Directors [*e.g.*, hostile takeovers], as well as the right to interest (Section 6.01); the right to convert into common stock (Section 12.01); the right to receive additional interest in the event of a default (Section 2.12); and the right to participate in a sinking fund and to acceleration of principal and interest due on the debentures in the event of a default (Art. 4 and Section 8.02)." Reply Memorandum in Support of Defendants' Motion to Dismiss the Amended Complaint and for a Protective Order Staying Discovery ("Def. Reply") at 9-10 (footnote omitted).

sion of material fact within the meaning of the federal securities laws. *See Koppel*, 575 F. Supp. at 967 (failure to disclose underlying motives does not violate Section 14(a) of the Securities Exchange Act of 1934 since "[t]he proxy rules require disclosure of the provisions, not the putative reasons behind proposing them") (citing *Lewis v. Oppenheimer & Co.*, 481 F. Supp. 1199, 1204 (S.D.N.Y. 1979); *Panter v. Marshall Field & Co.*, 646 F.2d 271, 290 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981)); *cf. Luce v. Edelstein*, 802 F.2d 49, 55 (2d Cir. 1986) ("making a *specific promise* to perform a particular act in the future while secretly intending not to perform that act may violate Section 10(b) where the promise is part of the consideration for the transfer of securities") (citations omitted; emphasis supplied); *Pross v. Katz*, 784 F.2d 455, 457 (2d Cir. 1986) (same). *But cf. Gulf & Western*, 476 F.2d at 696 (failure to disclose intention, when announcing tender offer, to take control of A & P or to participate extensively in its management constituted a violation of § 14(e)).

Since the Prospectus at issue clearly discloses all material facts (as opposed to legal conclusions) relating to the debentureholders' right to tender under Section 5.02 of the Indenture, I find that there is no basis for plaintiffs' claims that the Prospectus violated the disclosure requirements of Section 11 of the 1933 Act or Section 10(b) of the 1934 Act (Counts Three and Five).[20] *See Rubin*, 576 F. Supp. at 612 ("[w]hen

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20 Plaintiffs' reliance on *Harris v. Union Electric Co.*, 787 F.2d 355 (8th Cir.), *cert. denied*, 107 S. Ct. 94 (1986), is clearly misplaced. *See* Pl. Memo at 32. In *Harris*, the plaintiffs claimed that a prospectus misrepresented and omitted material facts regarding the "call protection provisions" of a bond contract, and that the attempted plan to call the bonds constituted a scheme to defraud the bondholders because the company knew that the plan was "contrary to and prohibited by the terms of the prospectus." The defendants argued, *inter alia*, that the prospectus clearly disclosed the company's right to call the bonds in the manner in which the plan provided. *Id.* at 361. In holding that the evidence supported the jury's finding that defendants' conduct operated as a fraud on the bondholders, the *Harris* Court wrote:

considering claims of material omissions under § 11 . . . and § 10(b) . . . , there is no question that they stand or fall together for the simple reason that both provisions impose liability for material omissions in virtually identical language"). I accordingly reject plaintiffs' contention that these claims raise disputed issues of fact barring entry of summary judgment for the moving party.

Count Four of the Revised Amended Complaint adds a claim under Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77L, based on oral statements allegedly made by officers and representatives of defendant Furman Selz to the effect that the debentures included a "special protection for debentureholders" and a "protective covenant" in the event of a takeover. *See* Revised Amended Complaint ¶¶ 42-43. Plaintiffs claim that these oral statements led plaintiff Thomas Revy to believe that the purpose of the right to tender was to protect debentureholders and that his investment would be returned to him in the event the harmful effects of a merger or excess debt occurred. *See id.* ¶ 44. Plaintiffs also claim that, "[i]n view of the Prospectus and the oral representations by Furman Selz, the failure to state that the right to tender could be eliminated in the unrestricted discretion of a majority of the directors constituted an omission to state a material fact necessary in order to make statements made, in light of the circumstances, not misleading." *Id.* ¶ 46. *See also* Letter to the Court dated July 6, 1988; Affidavit of Thomas

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> it is clear that the jury could have reasonably found that the prospectus is ambiguous and misleading *in that it omits material facts [as set forth in the bond contract] concerning the call protection.*

Id. at 364 (emphasis supplied). Citing *Harris*, plaintiffs argue that the Prospectus "failed to disclose that the Independent Directors could act . . . with 'unrestricted discretion' to nullify the right to tender, and gave the misleading impression that the right to tender gave debentureholders protection against mergers and highly leveraged transactions." Pl. Memo at 32-33. This argument is fatally defective in that, unlike the prospectus in *Harris*, the Prospectus here does not omit *any* facts with respect to the right to tender as set forth in the Indenture Agreement. Instead, the language of the Prospectus virtually mirrors that of Section 5.02 and in so doing clearly discloses that the optional right to tender only arises upon the occurrence of certain transactions not approved by a majority of the Independent Directors.

Revy (financial analyst and a principle of plaintiff Foley, Revy Investment Co., Inc.) ("Revy Aff.").[21]

As with Counts Four and Five, I find that there are no genuine issues of disputed fact with respect to the allegations set forth in Count Four and that defendants are entitled to judgment as a matter of law. Section 12(2) of the Securities Act of 1933 imposes liability upon any person who:

> offers to sell or sells a security * * * by means of a prospectus or oral communication, which includes an *untrue statement* of a material fact or omits to state a material fact necessary in order to make the statements * * * not misleading * * *.

15 U.S.C. § 77L (emphasis supplied). *See also Franklin Sav. Bank of New York v. Levy*, 551 F.2d 521, 525 (2d Cir. 1977); *Elfenbein v. American Financial Corp.*, 487 F. Supp. 619, 626 (S.D.N.Y. 1980), *aff'd mem.*, 652 F.2d 53 (2d Cir. 1981).

Assuming, as I must, the truth of plaintiffs' allegations, and drawing all inferences in favor of the non-moving party, the fact remains that plaintiffs have failed to allege a single "untrue statement"—material or otherwise—made with respect to the debentureholders' right to tender under the governing Indenture. As discussed *supra* at 22-23, the conditional redemption right in fact provides a valuable benefit to debentureholders in the event Wherehouse is subjected to a takeover not approved by a majority of the Independent

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21 In his affidavit, Revy states that Mr. Sean Gallager, an officer of Furman Selz, described the securities as "includ[ing] a provisional protection from redemption by the Company and 'special protection for the debentureholders' in the event of a takeover." *See* Revy Aff. at ¶ 3. Later, at a "due diligence" luncheon on July 2, 1986, another Furman Selz representative allegedly described the debentures as containing "a protective covenant for the debentureholders." *Id.* ¶ 4. He claims that these oral statements, in conjunction with the description of the right to tender contained in the Prospectus, misled him into believing that the debentureholders were protected against the harmful effects of takeovers and leveraged buy-outs.

Directors.[22] Thus it was perfectly accurate for the Furman Selz representatives to assert that the debentures contained a protective covenant for the debentureholders' benefit. I therefore agree with defendants that "these alleged oral statements are on their face not fraudulent because they are true." *See* Letter to the Court dated June 30, 1988.

Notwithstanding the literal truth of the alleged misrepresentations, plaintiffs argue that the failure on the part of the Furman Selz representatives explicitly to state that the right to tender could be waived in the unrestricted discretion of the Independent Directors misleadingly exaggerated the extent of the protection afforded by the redemption provision. This argument essentially restates the claims asserted in Counts Three and Five with respect to allegedly material omissions in the Prospectus and is equally unpersuasive. As discussed *supra* at 20-22, legal conclusions or characterizations simply do not constitute "omissions" within the meaning of the federal securities laws. This claim accordingly fails as a matter of law.[23]

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22 In a letter to the Court dated June 14, 1988, plaintiffs claim that the right to tender is "illusory" because "over 90% of all acquisitions (including hostile takeovers) are concluded with the agreement of the pre-existing directors." Thus, plaintiffs appear to suggest that there is a disputed issue of fact as to whether the conditional tender option is of any benefit to the debentureholders. This contention is meritless. Even assuming, as plaintiffs suggest, that 90 percent of all acquisitions are concluded by agreement, the fact remains that the conditional redemption provision at issue in this case would protect debentureholders in the assumed 10 percent of acquisitions *not* approved by a majority of the independent directors. Therefore, although the parties disagree about the extent of the benefit provided by the conditional right to tender, plaintiffs do not allege any genuine issue as to whether this provision is of *any* benefit to the debentureholders; *i.e.*, they effectively concede that the tender provision benefits the debentureholders in the event the company is subjected to a takeover or merger not approved by the majority of the Independent Directors.

23 Even assuming *arguendo* that this type of omission was actionable under the securities law, it is virtually inconceivable that "any reasonable investor" could have been misled by the Furman Selz statements in light of the clear and unambiguous language of both the Indenture and the Prospectus.

To conclude, I find that defendants have met their burden of demonstrating the absence of any genuine issues of fact with respect to the federal securities claims. Since plaintiffs have failed to allege any misstatements or omissions of fact within the meaning of the federal securities law, it is unnecessary to reach the issue of whether a reasonable investor could have been misled by defendants' representations concerning the nature of the conditional right to tender the debentures. I accordingly recommend that Counts Three, Four, and Five be dismissed pursuant to Fed. R. Civ. P. 56.

State-Law Claims:

Counts One, Two, Six, and Seven are predicated on state law; jurisdiction for these claims is based on the doctrines of pendent and ancillary jurisdiction. *See* Revised Amended Complaint ¶ 4. Defendants argue that, in the absence of a valid federal claim, this Court should not exercise pendent jurisdiction over the remaining state-law claims, and that those claims should accordingly be dismissed pursuant to Fed. R. Civ. P. 12(b)(1). *See* Def. Memo at 27-31. Defendant Chemical Bank also moves to dismiss Count Seven on the ground that the Court lacks pendent-party jurisdiction over the fraudulent conveyance claim. *See* Chem. Memo; Chem. Reply.

Absent "exceptional circumstances," dismissal of state claims for lack of pendent jurisdiction is the recommended procedure in cases where all federal claims are disposed of prior to trial. *Walker v. Time Life Films, Inc.*, 784 F.2d 44, 53 (2d Cir.), *cert. denied*, 476 U.S. 1159 (1986). *See also United Mine Workers v. Gibbs*, 383 U.S. 715 (1966); *Dunton v. County of Suffolk*, 729 F.2d 903, 910-11 (2d Cir. 1984); *McLearn v. Cowen & Co.*, 660 F.2d 845, 848 (2d Cir. 1981); *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1015 (2d Cir. 1975); *Kaplan v. Shapiro*, 655 F. Supp. 336, 342 (S.D.N.Y. 1987); *International Paint Co. v. Grow Group, Inc.*, 648 F. Supp. 729, 731 (S.D.N.Y. 1986); *Packer v. Yampol*, 630 F. Supp. 1237, 1243 (S.D.N.Y. 1986); *Gramercy 222 Residents Corp. v. Gramercy Realty*, 591 F. Supp. 1408, 1415 (S.D.N.Y.

1984); *Lewis v. McGraw*, 495 F. Supp. 27, 33 (S.D.N.Y. 1979). Having recommended that Counts Three, Four, and Five be dismissed pursuant to Fed. R. Civ. P. 56, I further recommend that Counts One, Two, Six, and Seven be dismissed as against all defendants including Chemical Bank pursuant to Fed. R. Civ. P. 12(b) (1) for lack of jurisdiction over the subject matter.

CONCLUSION

In summary, I recommend that Counts Three, Four, and Five of the Revised Amended Complaint (the federal securities claims) be dismissed pursuant to Fed. R. Civ. P. 56. I further recommend that Counts One, Two, Six, and Seven of the Amended Complaint (the state-law claims) be dismissed pursuant to Fed. R. Civ. P. 12(b)(1) for lack of jurisdiction over the subject matter.

Pursuant to 28 U.S.C. § 636(b) (1) and Rule 72 of the Federal Rules of Civil Procedure, the parties shall have ten (10) days from receipt of this Report to file written objections. Such objections shall be filed with the Clerk of the Court, with extra copies delivered to the chambers of the Honorable Mary Johnson Lowe, Room 803, and to the chambers of the undersigned, Room 631. Any requests for an extension of time for filing objections must be directed to Judge Lowe. Failure to file objections may result in a waiver of those objections for purposes of appeal. *Thomas v. Arn*, 474 U.S. 140 (1985); *Wesolek v. Canadair Ltd.*, 838 F.2d 55, 57-59 (2d Cir. 1988); *McCarthy v. Manson*, 714 F.2d 234, 237-38 (2d Cir. 1983).

DATED: New York, New York
August 10, 1988

KATHLEEN A. ROBERTS
United States Magistrate

Prospectus (Excerpts)

(Cover Page)

$50,000,000

Wherehouse Entertainment, Inc.

6¼% Convertible Subordinated Debentures
Due July 1, 2006

The 6¼% Convertible Subordinated Debentures Due July 1, 2006 (the "Debentures") are being offered by Wherehouse Entertainment, Inc. (the "Company"). The Debentures are generally convertible at any time prior to maturity, unless previously redeemed, into shares of Common Stock of the Company (the "Common Stock") at a conversion price of $34.50 per share, subject to adjustment in certain circumstances. The Debentures are redeemable, in whole or in part, at the option of the Company on 30 days notice at 106.25% of their principal amount if redeemed prior to July 1, 1988, and thereafter at prices declining to 100% on or after July 1, 1994, together in each case with accrued interest; except that the Debentures are not redeemable prior to July 2, 1988, unless the closing price of the Common Stock on each of any 20 trading days within a period of 30 consecutive trading days immediately preceding the date of the notice of redemption of the Debentures has been at least 140% of the conversion price then in effect. Each holder of the Debentures has the option to require the Company to redeem the holder's Debentures upon certain defined events. Annual sinking fund payments of $3,500,000, commencing July 1, 1996, are calculated to retire 70% of the Debentures prior to maturity. The Debentures are unsecured obligations of the Company and subordinated in right of payment to all Senior Debt of the Company, as provided in the Indenture. The Indenture will not restrict the Company from incurring any other indebtedness. See "Description of Debentures."

The Company's Common Stock is traded on the American Stock Exchange. The last reported sale price of the Common

Stock on the American Stock Exchange on July 9, 1986 was $28 per share. See "Price Range of Common Stock." The Company has declared a one for four stock distribution payable on August 15, 1986 to shareholders of record on July 25, 1986. Prior to the date hereof, there has been no trading market for the Debentures. Application has been made to include the Debentures in NASDAQ.

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

	Price to Public(1)	Underwriting Discounts(2)	Proceeds to Company(3)
Per Debenture	100%	2.8%	97.2%
Total (3)	$50,000,000	$1,400,000	$48,600,000

(1) Plus accrued interest, if any, from July 17, 1986 to the date of delivery.
(2) See "Underwriting" for information relating to indemnification of the Underwriter and other matters.
(3) Before deducting expenses estimated at $1,050,000 payable by the Company.

The Debentures are offered by the Underwriter, subject to prior sale and to receipt and acceptance by the Underwriter and subject to the Underwriter's right to reject any order in whole or in part. It is expected that delivery of the Debentures will be made on or about July 17, 1986.

Furman Selz Mager Dietz & Birney Incorporated

The date of this Prospectus is July 10, 1986

(Prospectus, p. 3)

PROSPECTUS SUMMARY

The following summary should be read in conjunction with, and is qualified in its entirety by, the more detailed information and Consolidated Financial Statements (including the notes thereto) appearing elsewhere in this Prospectus.

The Company

Wherehouse Entertainment, Inc., is one of the largest specialty retailers in the United States of home-entertainment and information software, including prerecorded music, video movies and other video programming, blank video and audio tape and personal and home computer software. All 158 of the Company's stores sell prerecorded music on compact discs, cassettes and records, video movies and other video programming, and blank video and audio tapes. In addition, 114 stores rent video movies and 127 sell computer software. The Company's stores are located predominantly in California, with 25 stores located in five nearby Western States. The Company's stores are located predominantly in California, with 25 stores located in five nearby Western States. The Company believes that it rents more video movies than any other retailer in the United States and sells more prerecorded music and blank video and audio tape than any other retailer in California.

The Offering

Securities Offered...	$50,000,000 principal amount of 6¼% Convertible Subordinated Debentures Due July 1, 2006.
Interest Payment Dates.....	July 1 and January 1, commencing January 1, 1987.
Conversion Price ...	$34.50 per share, subject to adjust-

	ment upon the occurrence of certain events.
Optional Redemption.....	Redeemable at the Company's option at any time, in whole or in part, on 30 days' notice, at 106.25% of the principal amount if redeemed prior to July 1, 1988 and thereafter at prices declining to 100% on or after July 1, 1994, together in each case with accrued interest; except that the Debentures are not redeemable prior to July 2, 1988, unless the closing price of the Common Stock on each of any 20 trading days within a period of 30 consecutive trading days immediately preceding the date of the notice of redemption of the Debentures has been at least 140% of the conversion price then in effect.
Optional Tender....	Each holder of Debentures has the option to require the Company to redeem the holder's Debentures, in whole or in part, at the greater of the optional redemption price or the Conversion Value of the Debentures, in the event that (i) any person or group attains beneficial ownership of at least 80% of the voting power for election of the Company's directors unless approved by a majority of the Company's Independent Directors; (ii) there is a merger or sale of the Company unless approved by a majority of the Company's Independent Directors; or (iii) the Company or any Subsidiary incurs

	certain Debt (not approved by a majority of the Company's Independent Directors) whereby the Company's Consolidated Total Debt exceeds 65% of Consolidated Capitalization.
Sinking Fund	Mandatory annual payments of $3,500,000 commencing July 1, 1996 are calculated to retire 70% of the Debentures prior to maturity. The Company may deliver Debentures (including converted Debentures) in lieu of cash as a credit against sinking fund payments.
Subordination	Subordinated to all current and future Senior Debt of the Company.
Use of Proceeds....	To finance the Company's new store opening and expansion program, including the acquisition of certain assets of a California retailer of home entertainment software products, and to reduce indebtedness under the Company's bank line of credit.
Common Stock Information.....	7,118,867 shares of Common Stock outstanding.

(Prospectus, pp. 25-27)

Optional Debenture Tender

Holders of the Debentures will have the option, for a specified period of 60 days, to require the Company to redeem such Debentures, at the principal amount thereof, in whole or in part, at the greater of (a) the optional redemption price as of the date of the event giving rise to the right of redemption or (b) the average of the Conversion Values of the Debentures for the 20 trading days immediately preceding the date of such event (such "Conversion Value" of a Debenture on any day being equal to the closing price of a share of Common Stock on such day multiplied by the number of shares of Common Stock (including any fraction thereof) into which such Debenture is convertible on such day), in the event that: (i) any person or group (within the meaning of Section 13(d)(3) of the Securities Exchange Act of 1934) attains beneficial ownership (within the meaning of Rule 13d-3 of the Securities Exchange Act of 1934) of at least 80% of the voting power for election of the Company's directors unless approved by a majority of the Company's Independent Directors; (ii) the Company consolidates with, merges into or sells or leases its properties and assets substantially as an entirety to any person or entity, unless approved by a majority of the Company's Independent Directors; or (iii) the Company or any Subsidiary incurs Debt (excluding Debt existing on July 9, 1986, and Debt authorized or ratified by a majority of the Company's Independent Directors) whereby the Consolidated Total Debt of the Company exceeds 65% of its Consolidated Capitalization (as such terms are hereinafter defined). This provision permits the holders of the Debentures to require redemption prior to maturity in the event the Company undergoes certain changed conditions as described above.

A redemption of the Debentures pursuant to this option may adversely affect the Company's financial condition and the market price of the Common Stock. This optional tender provision may deter certain mergers, tender offers or other

takeover attempts. See "Description of Debentures–Effect on Certain Takeovers."

"Consolidated Capitalization" is defined to mean the Consolidated Total Debt of the Company and its Subsidiaries plus its shareholders' equity and any preferred stock or other capital stock classified as subject to redemption and not included in its shareholders' equity plus minority interests in its Subsidiaries, as defined in accordance with generally accepted accounting principles.

"Consolidated Total Debt" is defined to mean the total Debt of the Company and its Subsidiaries, computed and consolidated in accordance with generally accepted accounting principles.

"Debt" is defined to mean: (i) any indebtedness of the Company (a) for money borrowed (other than the Debentures), (b) evidenced by a note, debenture or similar instrument (including a purchase money obligation) given in connection with the acquisition of any property or assets (other than inventory or similar property acquired in the ordinary course of business), or (c) for the payment of money relating to a capitalized lease obligation; (ii) any guarantee by the Company of indebtedness for borrowed money or indebtedness incurred as described in (i)(b) above; and (iii) any renewal, extension, refunding or amendment of any such indebtedness, obligation or guarantee.

"Independent Director" is defined to mean a director of the Company who is not, and has not been during the five years prior thereto, an employee of the Company and who either was a member of the Board of Directors of the Company on July 10, 1986, or who subsequently became a director of the Company and whose election, or nomination for election by the Company's shareholders, was approved by a vote of a majority of the Independent Directors then on the Board of Directors. Any action, approval of which shall require the approval of a majority of the Independent Directors, may be authorized by one Independent Director if he is the only Independent Director on the Board of Directors, but no such action may be taken if there are no Independent Directors on the Board of Directors.

"Subsidiary" is defined to mean a corporation a majority of the voting stock of which is owned, directly or indirectly, by the Company or by one or more other Subsidiaries, or by the Company and one or more other Subsidiaries.

Rule 13e-4 under the Securities Exchange Act of 1934 requires the dissemination of certain information to security-holders in the event of any issuer tender offer and may apply in the event that the optional tender provision becomes available to the holders of the Debentures. The Company will comply with this Rule to the extent applicable at that time.

Effect on Certain Takeovers

Certain features of the Debentures may deter certain mergers, tender offers or other present or future takeover attempts and may thereby adversely affect the market price of the Common Stock. The Indenture also provides that holders of Debentures shall have the option to require the Company to redeem their Debentures, in whole or in part, upon the occurrence of certain specified events. See "Description of Debentures—Optional Debenture Tender." Since the events which give rise to such right of redemption could be expected to occur in connection with certain forms of takeover attempts, the optional tender provisions could deter takeovers where the person attempting the takeover views itself as unable to finance the redemption of the principal amount of Debentures which may be tendered to the Company upon occurrence of such specified event. To the extent that Debentures may be tendered pursuant to the optional tender provisions, the Company would be unable to use the financing provided by the sale of the Debentures offered hereby. In addition, the ability of the Company to obtain additional Senior Debt based on the existence of the Debentures would be similarly adversely affected. Certain takeover attempts may also be deterred by the Company's authorized but unissued preferred stock. See "Description of Capital Stock."

* * *

Indenture (Excerpts)

INDENTURE dated as of June 15, 1986, between WHEREHOUSE ENTERTAINMENT, INC., a Delaware corporation ("Company"), and BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, a national banking association ("Trustee").

Each party agrees as follows for the benefit of the other party and for the equal and ratable benefit of the Holders of the Company's 6¼% Convertible Subordinated Debentures Due July 1, 2006 ("Securities"):

ARTICLE 1

DEFINITIONS AND INCORPORATION BY REFERENCE

SECTION 1.01 *Definitions.*

"*Affiliate*" means any person directly or indirectly controlling or controlled by or under direct or indirect common control with the Company.

"*Agent*" means any Registrar, Paying Agent, Conversion Agent or co-registrar.

"*Board of Directors*" means the Board of Directors of the Company or any authorized committee of the Board.

"*Company*" means the party named as such above until a successor replaces it and thereafter means the successor.

"*Default*" means any event which is, or after notice or passage of time would be, an Event of Default.

"*Holder*" or "Securityholder" means the person in whose name a Security is registered.

"*Indenture*" means this Indenture, as amended or supplemented from time to time.

"*Officer*" means the Chairman of the Board, the President, any Vice President, the Treasurer or the Secretary of the Company.

"*Officers' Certificate*" means a certificate signed by two Officers. See Sections 14.04 and 14.05.

"*Opinion of Counsel*" means a written opinion from legal counsel who is acceptable to the Trustee. The counsel may be an employee of or counsel to the Company or the Trustee. See Sections 14.04 and 14.05.

"*Principal*" of a debt security means the principal of the security plus the premium, if any, on the security.

"*SEC*" means the Securities and Exchange Commission.

"*Securities*" means the Securities described above issued under this Indenture.

"*TIA*" means the Trust Indenture Act of 1939 (15 U.S. Code §§ 77aaa-77bbbb) as in effect on the date of this Indenture.

"*Trustee*" means the party named as such above until a successor replaces it and thereafter means the successor.

"*Trust Officer*" means the Chairman of the Board, the President or any other officer or assistant officer of the Trustee assigned by the Trustee to administer its corporate trust matters.

SECTION 1.02 *Other Definitions.*

Term	*Defined in Section*
"Bankruptcy Law"	8.01
"Common Stock"	12.01
"Consolidated Capitalization"	5.02
"Consolidated Total Debt"	5.02
"Conversion Agent"	2.03
"Custodian"	8.01

Term	*Defined in Section*
"Debt"	13.02
"Event of Default"	8.01
"Independent Director"	5.02
"Legal Holiday"	14.07
"Paying Agent"	2.03
"Quoted Price"	14.13
"Registrar"	2.03
"Representative"	13.02
"Senior Debt"	13.02
"Subsidiary"	5.02
"U.S. Government Obligations"	10.01

* * *

ARTICLE 5

OPTIONAL SECURITYHOLDER TENDER

SECTION 5.01 *Holder's Right to Tender.* The Holder of any Security or Securities shall have the right, at his option, upon the giving of notice of the occurrence of any event described in Section 5.02, and subject to the terms and provisions of this Article, to tender for redemption any such Security or Securities, in whole or in any portion thereof that is an integral multiple of $1,000, without regard to whether the Securities are then redeemable under the optional redemption provisions of paragraph 5 of the Securities, for cash in an amount equal to the greater of (i) the applicable redemption price if such Securities were being redeemed pursuant to the optional redemption provisions of paragraph 5 of the Securities and (ii) the average of the conversion values of such Securities for the 20 consecutive trading days ending on the trading day immediately preceding the day on which the event giving rise to the right to tender shall have occurred, such conversion value of a Security on any day being equal to the Quoted Price of the Common Stock (determined as specified in Section 14.13) on such day multiplied by the number of shares of Common Stock (including any fraction thereof) into which such Security is convertible on such day

(the "tender redemption price"). The date of such redemption shall be the sixty-fifth day after the date of the notice provided pursuant to Section 5.03 (the "tender redemption date"). The Holder's right to tender shall continue up to the sixtieth day after the date of such notice and shall be exercised by surrender on or before such day of the Security or Securities to the Trustee accompanied by written notice that the Holder elects to tender such Security or Securities and (if so required by the Company or the Trustee) by a written instrument or instruments of transfer in form satisfactory to the Company and the Trustee duly executed by the Holder or his duly authorized legal representative and transfer tax stamps or funds therefor, if required pursuant to Section 12.04. All Securities surrendered for redemption shall be cancelled by the Trustee.

Section 5.02 *Events Triggering Holder's Right to Tender.* The Holder's right to tender under Section 5.01 shall be triggered upon the occurrence of any of the following events:

(a) A person or group (within the meaning of Section 13(d)(3) of the Securities Exchange Act of 1934) shall attain the beneficial ownership (within the meaning of Rule 13d-3 promulgated under the Securities Exchange Act of 1934) of an equity interest representing at least 80% of the voting power for election of the Board of Directors of the Company unless such attainment has been approved by a majority of the Independent Directors;

(b) The Company, directly or indirectly, consolidates or merges with any other person or sells or leases its properties and assets substantially as an entirety to any person, unless approved by a majority of the Independent Directors;

(c) The Company or any Subsidiary incurs, issues, assumes, guarantees or creates any Debt, or pledges any Company or Subsidiary assets to secure repayment of any Debt, excluding Debt existing on July 9, 1986 and Debt which is authorized or ratified by a majority of the

Independent Directors, immediately after the incurrence of which the ratio of the Company's Consolidated Total Debt to its Consolidated Capitalization exceeds .65 to 1.0; the ratio shall be calculated from the Company's latest published quarterly consolidated balance sheet, prepared in accordance with generally accepted accounting principles, adjusted on a pro forma basis as if such Debt existed as of the balance sheet date.

Capitalized terms used but not defined elsewhere in this Indenture have the meanings set forth below:

"*Consolidated Capitalization*" means the Consolidated Total Debt of the Company and its Subsidiaries plus its shareholders' equity and any preferred stock or other capital stock classified as subject to redemption and not included in its shareholders' equity plus minority interests in its Subsidiaries, as defined in accordance with generally accepted accounting principles.

"*Consolidated Total Debt*" means the total Debt of the Company and its Subsidiaries, computed and consolidated in accordance with generally accepted accounting principles.

"*Independent Director*" means a director of the Company who is not, and has not been during the 5 years prior thereto, an employee of the Company and who either was a member of the Board of Directors of the Company on July 10, 1986, or who subsequently became a director of the Company and whose election, or nomination for election, by the Company's shareholders was approved by a vote of a majority of the Independent Directors then on the Board of Directors. Any action, approval of which shall require the approval of a majority of the Independent Directors, may be authorized by one Independent Director if he is the only Independent Director on the Board of Directors, but no such action may be taken if there are no Independent Directors on the Board of Directors.

"*Subsidiary*" means a corporation, a majority of the voting stock of which is owned, directly or indirectly, by the Company or by one or more Subsidiaries, or by the Company and one or more other Subsidiaries.

SECTION 5.03 *Notice of Events.* Upon occurrence of any of the events described in Section 5.02, the Company shall file with the Trustee and shall mail to each Holder of Securities, as promptly as possible but in any event not more than 10 days following such occurrence, a notice stating that the event specified in the notice has occurred and that each Holder has the right to tender his Security or Securities for cash pursuant to the terms and provisions of this Article together with the form of the written notice of tender required by Section 5.01. Upon demand to the Company at any time by the Trustee or any Holder of Securities, such notice shall be filed with the Trustee and mailed to each Holder of Securities, unless the Company can demonstrate to the Trustee's satisfaction that no event described in Section 5.02 has occurred.

SECTION 5.04 *Deposit of Funds.* On or before the sixty-second day after the date of the notice provided pursuant to Section 5.03, the Company shall deposit with the Trustee or with a Paying Agent (or, if the Company is acting as its own Paying Agent, segregate and hold in trust as provided in Section 2.04) an amount of money sufficient to pay the tender redemption price plus accrued interest on all the Securities to be redeemed on the tender redemption date.

If any Security surrendered for redemption under this Article is converted, any money deposited with the Trustee or with any Paying Agent or so segregated and held in trust for the redemption of such Security shall be paid to the Company upon its request or, if then held by the Company, shall be discharged from such trust.

SECTION 5.05 *Securities Payable on Tender Redemption Date.* Notice having been given as aforesaid, the Securities to be redeemed shall, on the tender redemption date, become due and payable at a price equal to the tender redemption

price plus accrued interest and from and after such date (unless the Company shall default in such payment) such Securities shall cease to bear interest. Upon surrender of any such Security for redemption in accordance with Section 5.01, such Security shall be paid on the tender redemption date by the Trustee or Paying Agent at a price equal to the tender redemption price, together with accrued interest to the tender redemption date.

SECTION 5.06 *Securities Redeemed in Part.* Upon surrender of a Security that is redeemed in part, the Trustee shall authenticate for the Holder a new Security equal in principal amount to the unredeemed portion of the Security surrendered.

SECTION 5.07 *Default.* The occurrence of any of the events described in Section 5.02 shall not be deemed Events of Default under Section 8.01, except where provided otherwise in this Article. All other obligations of the Company provided in this Article shall be included as covenants of the Company for purposes of Events of Default pursuant to Section 8.01.

* * *

STATUTORY APPENDIX

Securities Act of 1933, § 11(a), 15 U.S.C. § 77k(a):

> (a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—
>
> (1) every person who signed the registration statement;
>
> (2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;
>
> (3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;
>
> (4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;
>
> (5) every underwriter with respect to such security.

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement,

then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

Securities Act of 1933, § 11(e), 15 U.S.C. § 77k(e):

> The suit authorized under subsection (a) of this section may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought: Provided, That if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable. In no event shall any underwriter (unless such underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting) be liable in any suit or as a consequence of suits authorized under subsection (a) of this section for damages in excess of the total price at which the securities underwritten by

him and distributed to the public were offered to the public. In any suit under this or any other section of this subchapter the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit, such costs to be taxed in the manner usually provided for taxing of costs in the court in which the suit was heard.

Securities Exchange Act of 1934, § 10, 15 U.S.C. § 78j:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities Exchange Act of 1934, § 21D(b)(4), 15 U.S.C. § 78u-4(b)(4):

> In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.

Securities Exchange Act of 1934, § 21D(e), 15 U.S.C. § 78u-4(e):

> (1) Except as provided in paragraph (2), in any private action arising under this chapter in which the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.
>
> (2) In any private action arising under this chapter in which the plaintiff seeks to establish damages by reference to the market price of a security, if the plaintiff sells or repurchases the subject security prior to the expiration of the 90-day period described in paragraph (1), the plaintiff's damages shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the security and the mean trading price of the security during the period beginning immediately after dissemination of information correcting the misstatement or omission and ending on the date on which the plaintiff sells or repurchases the security.
>
> (3) For purposes of this subsection, the "mean trading price" of a security shall be an average of the daily trading price of that security, determined as of the close of the

market each day during the 90-day period referred to in paragraph (1).

Securities Exchange Act of 1934, § 28(a), 15 U.S.C. § 78bb(a):

> The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. Nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder. No State law which prohibits or regulates the making or promoting of wagering or gaming contracts, or the operation of "bucket shops" or other similar or related activities, shall invalidate any put, call, straddle, option, privilege, or other security, or apply to any activity which is incidental or related to the offer, purchase, sale, exercise, settlement, or closeout of any such instrument, if such instrument is traded pursuant to rules and regulations of a self-regulatory organization that are filed with the Commission pursuant to section 78s(b) of this title.